# *The* New York Certified Public Accountant



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# BOOK REVIEWS

## Audit Practice Case

By Ernest Coulter Davies and John H. Myers. THE RONALD PRESS COMPANY, New York, 1953. Pages: xx + 312; $6.75.

Teachers on the alert for new audit case material will want to consider this set. The student is asked to act as the junior accountant—although the level of work required is closer to that of at least a semi-senior—in charge of the annual audit of a small furniture manufacturing company organized as a closely held corporation. The authors have succeeded in constructing an interesting and realistic situation.

The case consists of five parts bound in individual pamphlet form as follows:

Part I —Instructions and Miscellaneous Papers
Part II —Checks and Invoices
Part III—Journals
Part IV—Ledgers
Part V —Prior Year's Working Papers

The value of this case could have been enhanced by the inclusion of a set of prearranged working papers for use in the current audit. The provision of stock forms, such as a conventional work sheet with the columns properly headed and the account titles imprinted, would have spared the student time and drudgery. Perhaps a later edition will see the inclusion of this desirable material.

The instructions in Part I are clear and thorough. The authors have been complete, but have not sacrified perspective for the sake of cramming *all* types of auditing problems into the one set. They have contrived a number of errors presumed to have been made by the client's staff which the student-auditor is expected to discover. These mistakes include errors of a routine bookkeeping nature, as well as those concerning the application of accounting principles. The authors have wisely refrained from introducing indications of defalcation. The general ledger accounts seem to be out of balance by fifty cents. This difference does not appear to be a deliberate one; more likely it is the result of a typographical error. As the set now stands, the student will be unable to locate the source of the error without blocking out the ledger since the case does not provide the journals for the first eleven months of the year under review. The blocking procedure is a desirable exercise, but the time it consumes can generally be ill afforded in the shorter courses.

The set offers excellent practice in applying basic auditing procedures, such as the confirmation of receivables, the verification of inventory prices, and the vouching of accounts payable. In addition, the student is required

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to prepare, rather than to check, the adjusting entries for accruals and deferrals. The instructions form a complete audit program. Such auditing procedures as can not be carried out because of the limits imposed by a classroom situation are presumed to have been performed by an "assistant" and are so marked in the program.

The checks and invoices furnished in Part II are facsimiles of actual business documents. These papers have been perforated for easy removal, and they aid in making the student feel himself engaged in a true-to-life auditing assignment.

The journals and ledgers of Parts III and IV are generally standard in design. Unfortunately, the authors have chosen not to assign page or code numbers to the general ledger accounts. The journals are not paginated, nor do they display posting marks of any sort. There is no evidence on the journal page itself that the entries have been posted to the ledger.

The prior year's working papers illustrated in Part V are very well designed and have many interesting features. The forms used are clear and comprehensive, and should prove effective in providing a helpful guide to the student. Moreover, the authors have effected a sufficient number of changes in the current situation to preclude an indiscriminate adoption of the illustrative working papers.

The authors have estimated that the time required for completion of the set is sixty hours. However, the case has been so designed that the time requirement may be modified in either direction, at the instructor's option.

Despite the objections indicated above, this reviewer liked the case. It is the kind of an audit the wholeness of which the average student can easily envision. The authors have avoided a morass of detail in which even the good student may flounder. Yet, there is ample material to test fully the accountant's ingenuity and skill. The audit develops into a closely-knit affair, and the student never loses the thread of continuity. As the examination progresses, the student should gain a feeling of accomplishment and a strengthened self-confidence.

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# BOOK REVIEWS

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**Theory and Technique of Cost Accounting**

By Lawrence L. Vance. THE FOUNDATION PRESS, INC., Brooklyn, N. Y., 1952. Pages: xv + 612; $5.50.

This book is the latest addition to the Foundation Press accounting series which includes texts on the elementary, intermediate, and advanced accounting levels.

As expressed in the preface, "This text is designed for the typical one-semester college course in cost accounting. It presumes that the student knows only the fundamentals of double-entry accounting." Mention is also made that full utilization of the laboratory problems provides sufficient material for a longer course. The material referred to consists of the chapter problems—no practice sets accompany the text.

After an introductory chapter, basic techniques, terminology, and the manufacturing cycle are presented for both job order and process cost systems. Chapter 4 discusses the voucher system, presented as an optional topic, and the factory ledger. The four chapters which follow are used to explain the detailed procedures and problems of accounting for material (chapters 5 and 6), labor (chapter 7), and overhead costs (chapter 9). At the conclusion of this last chapter, a summary of the principal entries for job order cost accounting is presented. Chapter 9 discusses periodic statements and reports. Although the text is not divided into parts, the foregoing may be considered "part" 1.

The second "part" consists of a two-chapter discussion of process costs and a single chapter devoted to joint and by-product costs. "Part" 3, precomputed costs, commences with estimated cost systems and then, in chapters 14 and 15, covers the elements of standard cost accounting, as conventionally presented. In the following chapter (16), the author contrasts his logical with the conventional analysis of variances. Readers will recognize this delineation as having appeared in an article by Dr. Vance in the March, 1950, issue of *The New York Certified Public Accountant*, pages 139-44.

The final "part" includes single chapters on distribution costs, administration costs, budgeting, and managerial cost analysis. Undoubtedly, some teachers will prefer to introduce budgeting before taking up precomputed cost systems.

The reader will discover that on a number of points the author may be challenged on accounting or pedagogical grounds:

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## Book Reviews

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"The amount of direct cost can be definitely or directly identified with the object of costing; the amount of indirect cost cannot" (p. 17). No comment regarding the fundamental criterion of expediency is to be found.

"When goods are sold this entry is made:
Dr. Cost of Goods Sold
Cr. Finished Goods" (p. 32).

No reference is made to the entry to be made at the selling price, and none of the related chapter problems require such an entry. Moreover, when job order cost entries are summarized in an exhibit presented later in the text, no sale transaction is included—either at cost or selling price. The soundness of taking the student, who "knows only the fundamentals of double entry accounting", through the manufacturing cycle only, without completing the accounting cycle, seems doubtful.

In exhibit 7 (p. 38), the factory payroll account is listed as normally having a credit balance. However, the illustration that immediately follows reflects no balance in that account. Substantiation for the credit balance statement is not found until page 191, and then the job order summary exhibit (p. 251) reverts to the method whereby the factory payroll account is a clearance account, with no balance. Any confusion that may result can only be increased by an error that appears in the payroll distribution entry in the latter exhibit.

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## BUSINESS AND PERSONNEL OPPORTUNITIES

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The chapters on material accounting contain no reference to cost or market valuation of inventories, nor to inventory reserves.

The preface of the text notes that "The material of this book has been presented in lectures at the University of California over a period of several years. . . ." Such use has produced many fine features. Numerous diagrams are simply and effectively presented throughout the text. In addition, a large number of forms, keyed to practice, are illustrated. The process cost presentation includes both the first-in and average methods, and contains a good treatment of normal and abnormal spoilage. The author is to be commended for bringing out the distinction between joint and common costs. The last chapter, managerial cost analysis, is excellent; both the preparation and interpretation of a profit graph are described, and then its major limitations are presented—the latter is a most welcome discussion.

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# THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

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*The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.*

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# Depreciation Calculated on Replacement Cost vs. Depreciation on Historical Cost

By JOHN PEOPLES, C.P.A.


*The author summarizes the views of the American Institute of Accountants and the Institute of Chartered Accountants. He ventures to disagree with their position that in determining income for statement purposes, it is not presently desirable that the depreciation charge should be supplemented to recognize changes in the purchasing power of money.*


I AM not going to say much about depreciation on historical cost as this is the usual method and one with which you are all familiar. The term "replacement cost" has a different meaning to different people. To me, as an acceptable basis for computing depreciation, it means original cost adjusted to reflect changes in the purchasing power of money. It is in this sense that I will use the term throughout this paper.


JOHN PEOPLES, C.P.A., is a member of our Society and of the American Institute of Accountants. He is a member of the Institute's Committee on Accounting Procedure. Mr. Peoples is a partner of Peat, Marwick, Mitchell & Co., C.P.A's.



This paper was presented at the Accounting Conference of the United States Independent Telephone Association in October, 1952.


The question as to whether there should be any revision in the method of computing depreciation is, of course, part of the larger problem of the effect of price level changes on the determination of income.

The previous speaker (Mr. E. E. Knaub, Chief Accountant of the Ohio Public Utilities Commission) put it very aptly when he said that "Financial accounts today do not sufficiently distinguish between a return on capital and a return of capital." Let me illustrate this by a simple example.

After the last war upon discharge from the armed services a young man decides to start a taxi service. He buys two cabs and at the end of the year hires an accountant to write up his books and prepare the tax return. The accountant provides depreciation at 25% per annum and reports that there is a profit of $500. Our returned soldier does not wish to expand and believes that "profit" is something he can take out of the business if he

wishes, without impairing it, so he buys his wife a fur coat. This goes on for three more years and each year the profit is withdrawn for one purpose or another.

The cabs begin to get the worse of wear and our hero decides to trade them in and finds that he can get little more than one cab for the cash he has accumulated, plus the trade-ins. Surely he is entitled to complain to his accountant that four years ago he had two new cabs while today he has only one, not much different from its predecessors, so that despite all his hard work where did he profit. This is exactly what is happening in business today on a larger scale.

## Permanent High Price Level

Most people will agree that we have reached a new price level from which there appears to be no likelihood of any substantial decline. Despite the obvious effect of this on current accounting conventions many accountants still feel that original cost provides the only true basis on which to compute depreciation. They argue that this basis is well established and well understood and that they are not justified in introducing estimates and the element of uncertainty that goes with them.

There can be no argument with this position where the price level remains on a reasonably stable basis during the life of the asset which is being depreciated. This is not the situation today and it is contended that depreciation should be adjusted to recognize the increase that has taken place in the replacement cost of plant and equipment. Under present circumstances existing accounting conventions do not give an accurate measurement of profit. Where there has been runaway inflation it has been necessary to adjust the accounts if they were to have any meaning but in the dollar and sterling areas, because the problem has been more in the nature of a creeping paralysis, accountants have been loath to change. They have, however, given much thought to the question and we might well consider the conclusions reached by the Study Group, the American Institute of Accountants and the Institute of Chartered Accountants of England and Wales.

## Report of Study Group

Probably the most thorough and complete presentation of the problem to date is that of the Study Group composed of 61 lawyers, economists, accountants and business executives. Not all of them continued with the group during the several years of study but 44 signed the report entitled "Changing Concepts of Business Income." Of those signing, eight recorded dissents of one kind or another, despite the rather mild conclusions reached in the report of which the following paragraph is among the more significant:

> "For the present, it may well be that the primary statements of income should contrive to be made on bases now commonly accepted. But corporations whose ownership is widely distributed should be encouraged to furnish information that will facilitate the determination of income measured in units of approximately equal purchasing power, and to provide such information wherever it is practicable to do so as part of the material upon which the independent accountant expresses his opinion."

Having noted that there is general agreement that the effects of inflation are important and that there should be an attempt made to explain to stockholders, workers and others the need to set aside a substantial part of the "profits," let us consider why objection is voiced to making this explanation through the medium of the income statement.

Opponents of change argue that to make adjustments for changes in the value of the dollar would (a) confuse the readers of financial statements; (b) make comparisons with prior years impossible and (c) cause accounting to lose much of the uniformity which it has gained in the last few decades.

Actually the adjustments with respect to the change in the value of the

dollar would preferably be shown separately in the income statement. This should not confuse the reader who understands a financial statement and would, if anything, make comparisons with prior years more meaningful.

**American Institute of Accountants**

The objection to lack of uniformity seems primarily the one that the Committee on Accounting Procedure of the American Institute of Accountants had uppermost when it issued its bulletin on "Depreciation and High Costs" in December, 1947, and reached the conclusion:

> "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedures should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time."

The argument in the first sentence has some merit but by itself is not a convincing one for postponing change especially when the committee recognizes that accounts prepared under FIFO, LIFO, or partial LIFO are all in compliance with generally accepted accounting principles. To re-hash the old example of the pair of shoes—They can be shown as having a cost of $5, $7 or $6 by three different companies where the first uses FIFO, the second LIFO and the third partial LIFO limited to the leather content. If the shoes are sold for $7, I, as a member of the Institute, can report that the profit of the first company is $2, the second nothing and the third $1. At the end of the transaction each company has the same number of identical pairs of shoes as at the beginning. Unfortunately, in the exchange, in the case of the two companies showing a profit, half or more of it must be paid in taxes on income so that actually they are worse off than before in terms of real wealth.

The second argument of the committee is also not convincing. Five years later there is still no sign of stability and from the encouragement given by government it would appear that prices will continue to rise, at least under the present administration. Furthermore, there is no way of compelling business as a whole to make the change at the same time, though a tax concession might accomplish this in most cases.

It must be recognized that this bulletin was written in the early days of the controversy. The committee has not given the matter serious consideration since that time. While the present members might be still of the same opinion, this pronouncement does not necessarily represent the current thinking of the committee. It is to be hoped that in the near future the committee will consider the matter again and make its present views known.

**Institute of Chartered Accountants**

Some of those who apparently are not unsympathetic with proposals for change in the method of determining income feel that there is no practical method of achieving the desired end. The Institute of Chartered Accountants of England and Wales might be placed in this category. They state that arguments have been presented for all of the undermentioned methods to overcome the limitations of computing depreciation on the historical cost basis:

1. The replacement cost method whereby the income statement is charged with amounts needed to provide for the cost of replacement of fixed assets.
2. The writing up of fixed assets on an appraisal basis and thereafter providing depreciation on the new values.
3. Providing depreciation on the current replacement cost of the fixed assets so that the charges for depreciation for any particular year would be adjusted to approximately what they would have been if the assets had been purchased at prices ruling in that year instead of when they were in fact purchased.

The arguments presented by the Chartered Accountants against the first

method are the difficulties of determining the replacement cost with the result that wide scope is left for extremes of personal opinion in determining each year the charge to be made in computing profits. Improved methods of production and new inventions often render existing plant obsolete with the result that when it is replaced the new equipment is of a different character from the old. The arguments against the third method are somewhat similar. Estimates of current value are partly a matter of personal opinion and where they are determined by applying price indices according to the year of purchase the amount provided may vary widely depending upon the index selected. In both cases it is argued that where prices continue to rise it would be necessary to go back and adjust the amounts provided in earlier years because they would then be insufficient to meet the replacement cost at the new higher values.

The argument against the second method of writing up the fixed assets is that the purpose desired would not be accomplished unless the timing coincided with the limit of inflation and thereafter prices remained stationary.

By way of rebuttal it might be said that proponents of change in the manner of computing depreciation in this country are not generally advocating methods 1 or 2 and, while they favor method 3, the proposal generally is to arrive at the replacement cost through the application of index numbers rather than depending upon the judgment of individuals. The argument that it would be necessary to go back and adjust the provision of earlier years might be valid in situations where the equivalent of the depreciation charge was added to cash. In actual practice the additions to plant in recent years have usually approximated or exceeded the depreciation provision. In that event the argument no longer holds water.

Apart from the accounting problems, the Institute of Chartered Accountants points out that any new concept of profit would raise much wider economic and social issues. If stockholders are granted some measure of protection against inflation, should there be legal recognition of changes in the purchasing power of money so as to adjust legal rights which have been expressed in terms of money; e.g., investments in government and other stocks and shares, rents under leases, pensions, insurance policies, debentures and other liabilities, rights under service agreements and profit-sharing schemes to incomes which are dependent on or vary with profits, and the relative rights of life tenants and remaindermen. This new conception of income would relieve business of a large amount of taxation in a period of rising prices and would, therefore, raise the further question of how the burden of that relief is to be distributed over the taxpayers.

None of these arguments denies the fact that with the decline in the purchasing power of the dollar the figure of income as at present computed is misleading. If it is distributed, a part of the capital has in fact been returned, and what is worse, both the corporation and the stockholder are paying taxes on it. The opponents of change without denying the basic argument prefer to do nothing because the suggested methods are not perfect and like all accounting concepts never can be, and in any case, they suggest we should wait until the woes of all others affected by the decline in the value of the dollar are corrected. The American stockholder with the crushing burden of double taxation, first on the corporate profits and secondly on what is available by way of dividends, needs no apology in attempting to have profits determined on a basis which does not include a return of capital.

### Proposal for Adjustment

Let us consider how, as a practical matter, profits computed in the usual way may be adjusted to reflect the

changes in the purchasing power of the dollar.

Most of the items in the income statement are reflected in current dollars. The major exceptions are product costs carried forward in inventories and costs representing provision for depreciation of fixed assets. We have made passing reference to LIFO. Its adoption has to a considerable extent brought about a substantial correlation between sales prices and the current cost of raw materials entering into cost of sales. It has disadvantages where there has been a substantial and permanent decline in quantities in the case of certain materials. As a result, income, instead of being charged with current replacement costs, is charged at prices prevailing when the LIFO method was originally adopted and when presumably prices were much lower. By and large where there is stability in inventory quantities LIFO has been reasonably successful in helping to match current costs against current income. A comprehensive discussion of LIFO is, however, outside the scope of this paper and we can turn to the question of depreciation.

Earlier, in looking at some of the problems cited by the Institute of Chartered Accountants, it was admitted that attempting to provide depreciation on estimated replacement cost would pose many difficulties if, by this definition, we mean to go further and attempt to determine the nature of the replacement after taking into account present and expected technological improvements. This would only be part of the problem. It would also be necessary to estimate the expected future cost of the replacement and, of course, this estimating would have to be done from year to year in the light of current information. All this would be so dependent upon personal opinion that no accountant would be willing to certify to financial statements prepared on such a basis. However, depreciation based on original cost adjusted through the application of index numbers, depending upon the year when the expenditure was made, would not be subject to this criticism.

Where the information is not already available, it will be necessary to analyze the plant account by classes of depreciable assets and year of acquisition, though it would seem sufficient to group the net acquisitions of 1939 and earlier years in one figure. Depreciation will be computed in the usual way and then adjusted on the basis of a suitable index. What is suitable is open to argument. Some economists and accountants will argue that special indices should be developed for particular businesses, not on an over-all basis, but by applying say half a dozen or more specially constructed tables depending upon the content of the varying fixed asset classifications. The argument is persuasive up to a point, but it should be remembered that at best the answer will be an approximation and it may be that the results obtained will not be worth the trouble as compared with the adoption of an index compiled by an outside agency. While all indices are subject to criticism, a company-developed one would not be so readily acceptable by labor, the public accountant and others. I would agree with Percival F. Brundage that "A general index like the Bureau of Labor's consumer's price index or its wholesale price index or some other index prepared for the purpose is, in my opinion, more suitable than a construction index, since we are not attempting to convert any particular unit into dollars but only to reflect changes in the general price level so that the dollars of income and expense will be roughly of the same size."

Index numbers have been criticized because of all things in this world, they are not perfect. Despite this they have been accepted in the determination of wage rates and the computation of inventories for tax purposes. Can it be argued that they are too much in the realm of estimates? I hope you will agree with me that depreciation com-

puted on the basis of index numbers results in a figure of net income which is far closer to reality than the figure of profit arrived at under our current accounting conventions.

**Treatment in Financial Statements**

Our next consideration is how to reflect the adjustments in the financial statements. To facilitate comparison with prior years and with other companies that continue to determine profits under our present concepts, it would be desirable to arrive at a figure of income based on historical cost and to show below this the adjustment arising from the change in the value of the dollar. The final figure would be income for the year based on current dollars. No radical changes would be shown in the balance sheet. The plant accounts would continue to be reflected at historical cost. Depreciation would be deducted therefrom based on this cost and the additional provision to cover the increase in replacement cost could appear on the liabilities side. Such a presentation would facilitate comparisons rather than hinder them. The public accountant would not be faced with results influenced by the the whim of management and could readily satisfy himself as to the consistency of treatment from year to year. It is this fear of being confronted with charges arising from the subjective judgment of company officials and which are incapable of measurement which makes the public accountant so reluctant to depart from cost as a basis on which to compute depreciation.

**Implementation of Proposals**

If we are convinced of the wisdom of a presentation along these lines, how can it be accomplished as a practical matter in the statements that go out to stockholders? First of all it is essential that business executives consider that change is desirable. In a survey made by the American Institute of Accountants about four years ago, business men and bankers were opposed by three to one. The controllers were also against change. In only one group—the economists—was the majority in favor of a move toward economic income. Since that time inflation has continued and there might be a reversal in a poll taken today. However, any change whereby profits shown are lower than those of a competitor who has not adopted the change, might not be a popular proposal. This objection would be partially overcome by the suggestion to present the figures so that income on both bases was shown.

It would be essential for the public accountants to be convinced of the need for a change in the method of determining income. A bulletin from the Committee on Accounting Procedure of the American Institute of Accountants that depreciation based on adjusted historical cost was an accepted accounting practice would be of great help in discussions with the Securities and Exchange Commission, the New York Stock Exchange and the various regulatory authorities. It was the acceptance of LIFO by the public accountants and the adoption of it by a few companies that paved the way for the change in the income tax regulations. Without their support it is unlikely that any rapid progress could be made. On the other hand, general acceptance by all other groups could not be long opposed by the public accountants.

**Regulated Companies**

In the case of industrial companies, their so-called profits in recent years have been sufficiently high to set aside substantial amounts after paying dividends so that the equity of the stockholder is preserved despite the inadequacy of the depreciation charge. In the case of the regulated companies, they have been limited to a rate of return which does not permit any large retention of earnings. For this reason

some accountants feel that, while depreciation based on replacement cost should be a permissive practice in the case of industrial companies, it should be mandatory in the case of regulated companies. A minority have a feeling that a stockholder in a public utility has an assurance of a reasonable return, in terms of current dollars, that almost puts him in the position of a creditor or holder of senior securities and consequently he is not entitled to protection against inflation. Former stockholders of street railroads might well dispute this argument. While the telephone and power companies at present seem reasonably assured of selling their wares in a non-competitive market there is no assurance in this age of advanced technology that the apparent assurance will continue.

If depreciation were permitted on the basis of replacement cost, should the excess over depreciation on historical cost be deducted from the plant account for purposes of rate making? I raise this question because an eminent authority has suggested that the deduction should be made but I can see no merit in it as this would defeat the whole purpose of what we are trying to accomplish. If depreciation on a replacement basis were accepted by the regulatory authorities, replacements of plant could be made from additional funds retained in the business. As these replacements were made in depreciated dollars the value of the plant for rate and accounting purposes would increase without the necessity of issuing additional capital. With the increase in the base, increased dividends could be paid to compensate for the decline in the purchasing power of money. The base obviously would not increase if the additional provision were deducted.

There is another problem which applies to all companies but which is perhaps more significant in the case of regulated companies because of the high ratio of debt to equity capital. Should the adjustment in depreciation be granted on the entire plant or only on that part which has been constructed with equity funds? I must confess, apart from the practical question of how you would identify these funds, that I have difficulty coming to a conclusion on this point, so I will fall back on a quotation from an article by Mr. Arthur H. Dean in a recent number of the *Harvard Law Review*:

> "The failure of the commissions to allow adequate rates to protect the utility stockholder from loss of his economic capital by inflation seems contrary to the principle recited in the Hope case that 'the returns to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.'
>
> "But for the sake of argument let us suppose rate bases were generally determined on replacement values instead of original costs and let us assume that the stockholder's economic equity might gain as against the bondholder's. We must then ask whether the aim should be limited to preserving intact only the stockholder's economic equity rather than the total real investment. If so, will not the effect be to take from the stockholder the capital to which he would otherwise have fallen heir from the bondholders and to distribute such capital to the present consumers, incidentally impairing the capital available for serving future consumers? It is difficult to find any legal or equitable principle which would justify such a result."

## Conclusion

Are we agreed that where plant is a substantial part of the assets, the figure of income computed under present accounting concepts does not represent earnings which can be distributed as dividends even where there is no intention to expand? To put it conversely, if the so-called profits are distributed, must the company shrink in its ability to produce or else be forced to increase its capital? If this is the end result, should accounting concepts be modified and are we all willing to do something about it? It is not a sufficient answer that when things get worse it will be time enough, or that change should be postponed until accounting techniques are perfect.

# Current Trends in Accounting

*By* Leo Rosenblum, C.P.A.

*Some Capsules Reflecting Modern Practices and Current Problems and Conditions*

### Something New in Retail Accounting

*Production unit accounting,* a new method of expense analysis for retailers, will do for retailing, it is predicted, what standard cost accounting has done for industry. So forecasts Raymond F. Copes, general manager of the Controllers' Congress of the National Retail Dry Goods Association.[1]

Under this system the expense account is the *expense center* or, as some stores call it, the *work center.* Accounting emphasis is placed on finding the out-of-pocket controllable cost of each of the jobs making up the work of the store; historical cost is of lesser interest.

Costs are analyzed in terms of work load, pay rate, and, most important, productivity. Variations in the cost of performance are measured as between stores and periods; as between budgeted and actual costs.

Tradewide adoption of production unit accounting, says Mr. Copes, "will be the most revolutionary development in retailing since the inception of the Retail Inventory System". The Standard Expense Accounting Manual of the Controllers' Congress is now under revision (the task will require about two years); its completion will facilitate use of the production unit accounting technique by the entire industry.

For computations showing how the method works, see the NRDGA's magazine, *Stores,* for January 1953.[2]

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### "Quarterly Earnings Reports . . . Valueless and Dangerous"

From a note in *The New York Times:*[3] "John Holmes, president of Swift & Co., told stockholders at the annual meeting today that publication of quarterly earnings reports in the meat-packing industry was valueless and dangerous."

The company does not issue quarterly statements; Mr. Holmes considers them unsatisfactory since "such quarterly reports are not indicative of the results of the entire year"; the operations of the industry must be examined "in terms of the complete cycle for the year."

It appears that of the major packers Armour & Company alone issues quarterly reports, and that company has been doing so for only a few years.

[1] Copes, Raymond F., "Production Unit Accounting," in *Stores,* Vol. 35, No. 1, Section 1, January 1953, p. 14.

[2] Pp. 14, 36-37.

[3] January 16, 1953.

### Position Unchanged

During its fiscal year 1952, the SEC reports,[4] there was renewed advocacy—"not concurred in to any large extent by accountants and corporate officials generally"—of the theory that depreciation of fixed assets "is related directly to replacement" and that "provisions from income for depreciation are inadequate unless they will provide for the replacement of the applicable assets" upon retirement from service.

Some who uphold this position, notes the SEC, "would, in effect, abandon historical costs completely by adjusting such costs in financial statements, to reflect changes in purchasing power of the dollar."

However, the Commission continues to require historical costs; "has found no justification for changing its requirements. . . ."

### Trial Court Overruled

Accountants will be interested in the outcome of a personal injury case in Missouri,[5] where the state Supreme Court overruled the trial court on a point concerning tax information. The trial court had erred, the Supreme Court ruled, in refusing to permit the defendant, a railroad company, to ask the plaintiff's witness, an actuary, whether he knew that there was no income tax on awards for personal injury.

A further error was the trial court's refusal of the defendant's request for an instruction informing the jury that no income tax could be assessed upon an award for personal injury and that nothing should be included in the jury's verdict "for Federal, State or City taxation."

The Court said that there was no sound reason for refusing to instruct the jury that the award would not be subject to such taxation; in the Court's opinion "the average juror would believe that any award was subject to such taxes."

### One Error in 3,000 Postings

The British magazine *Accountancy*, comments[6] upon an incentive plan, actually in use, covering operators of bookkeeping machines. Based upon time and motion study, a standard unit was evolved under the plan, with allowance for variations from the standard.

The bonus could amount to 15 per cent of basic pay. However, in 3,000 postings a single error is allowed. For exceeding this, the operator is penalized by a deduction from the bonus.

### Formula for Peace in Industry

From a luncheon address by Harold Watkinson, M. P., Parliamentary Secretary to the Ministry of Labour before the London and District Society of Chartered Accountants, London, in January:

> "If your profession . . . could translate the average company balance sheet into a single document that would make plain to every employee of the company the true relationship between net profits and capital, between wages, raw material costs and gross profit, you would do more to help productive efficiency and good relations in industry than any other body can do in years of unremitting effort."[7]

### Defining A Good Tax System

What are the characteristics of a good tax system? After a point by point description, two National Association of Manufacturers executives summarize as follows: "In simple words, a good tax system would aim at shearing an ever-growing crop of wool from the sheep year by year without shaving those with the thickest coat so close that discouragement and dissaffection would set in."[8]

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4 Securities and Exchange Commission, 18th Annual Report, Fiscal Year Ended June 30, 1952, pp. 182-183.

5 Dempsey vs. Thompson, 251 S.W. 2d 42 (Missouri), (September 8, 1952).

6 Vol. LXIII, No. 711, November 1952, p. 360.

7 *The Accountant*, Vol. CXXVIII, No. 4074, January 17, 1953, p. 63.

8 Bunting, Earl and Maher, Edward, "They Want to Know" (New York: Farrar, Straus and Young, 1952), p. 29.

### Cooperation Among Accountants

The Florida Institute of CPAs reports an interesting case of cooperation among local accountants.[9] Two CPA firms in Broward County assisted a third in performing the audit of the city of Hollywood. No single firm was in position to undertake the engagement unassisted; working together, the three firms retained the work locally.

### How Much Is in the Tank?

Robert H. Browse, CPA, of Philadelphia, offers a "Simplified Method for Tank Content Conversion to Help Accountants Verify Liquid Inventory." Writing in the *Journal of Accountancy*[10] he presents a "worked-out table" with directions and examples. These will help you verify the contents of tanks of different shapes.

### First Step on a Long Journey

*The New York Times* reports[11]: "Nicaragua's first income tax law will become effective Jan. 1, 1953, according to Minister of the Treasury Rafael Huezo." The tax range is from "4 per cent on incomes not exceeding $8,000 up to 18 per cent on incomes of more than $20,000."

### New Business for Small Clients

The Small Defense Plants Administration recently announced[12] the formation of a new small business production pool. It is made up of five small companies in New Jersey and Pennsylvania; together they employ a total of about 50. Seeking defense contracts in the machining, fabrication, and assembly of metal and wood products, their facilities will be available as a unit.

Possibly such arrangement is feasible for one or more of your small clients.

### Cost Secrets

Are costs business secrets? How much does a manufacturer know about competitors' costs of operation? *Fortune*[13] offers an answer.

"Our company", says a seller of automobiles, "can take a competitive car . . . apart piece by piece, apply our own cost formula, and come awfully close to figuring their costs, because their costs aren't very different from ours."

He adds that automobile manufacturers don't reveal their costs to competitors. While a particular manufacturer might employ a better method or machine yielding a cost advantage for a time, "the competition will probably find it out eventually."

Nevertheless, points out an automobile executive, "Costs is one thing that you never hear discussed at the Detroit Athletic Club".[14] And although each executive knows that his competitors are taking his car apart for a cost study, "each appears to count on some uncertainty in the other's counter—cost analysis, and of course there is a time lag."[15]

### Controllers' Reports

What points should the controller cover in his reports to management? This list is based upon Glenn E. Martin, CPA's, address before a group of Canadian chartered accountants:[16]

(1) Highlights of recent financial and operating trends.

(2) Balance sheets; working capital summaries; statement of funds; summary of cash balances.

(3) Significant data concerning receivables; analysis of inventories; summary of property accounts and accumulated depreciation allowances.

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9 *News Notes* (Bulletin of Florida Institute of Certified Public Accountants), Vol. III, No. 6, November-December 1952, p. 6.

10 Vol. 95, No. 1, January 1953, pp. 60-63.

11 December 21, 1952.

12 *The New York Times,* December 4, 1952.

13 McDonald, John, "Strategy of the Seller—or What Businessmen Won't Tell," Vol. XLVI, No. 6, December 1952, pp. 124-137, 196-198.

14 *Ibid.,* p. 127.

15 *Idem.*

16 *Canadian Chartered Accountant,* Vol. 62, No. 1, January 1953, pp. 7-8.

(4) Summary of accrued federal income taxes; purchase commitment data.
(5) Summary of retained earnings.
(6) Statements of income; sales summary; cost of sales data; selling, general, and administrative expenses.
(7) Significant operating and turnover ratios; basic materials price trends; product costs and net profits.
(8) Interpretive comments; charts and graphs illustrating significant trends.

**Lower Insurance Costs**

The *Journal of Accountancy*[17] quotes from the address of Sidney L. Hall, Vice-President of the Cleveland Electric Illuminating Company, before a recent American Management Association insurance conference. Mr. Hall points out the advantages of "deductible" coverage, a type familiar to automobile owners. Where policies contain such clauses, insured and insurance company share the losses, the insured paying the first part of a loss and the insurer the remainder.

Mr. Hall notes that such insurance is cheaper. At the same time, he observes, it tends to prevent losses: the insured will be "more careful in the selection and maintenance of his equipment, in the planning of his operation, and in good housekeeping generally."

**Down Under**

Tax problems are the same almost everywhere. Here are some caption headings from the section on "Current Taxation" in the *Australian Accountant*:[18]

False Declarations (for tax instalment purposes); Exemption of Income from Gold Mining; Living-Away-From-Home-Allowance; Expenses Incurred by Individual Partner in Gaining Partnership Income; Reimbursement of Employee's . . . Expenses . . . On Employer's Behalf; Donations Made for Business Reasons; Sum Received for Goodwill of . . . Business; Compulsory Expenditure by Tenant to Adapt Premises for Use as Cafe.

**Industrial Accountants Prescribe**

What does the industrial accountant like least about the public accountant's visit to his office? Indianapolis panelists making up a technical session of the Indiana CPA Society discussed the industrial accountant's pet peeves about the visiting public accountant.[19]

Here is what they would like us to do: (1) Plan the audit program better so that there will be less interruption of the client's routine; (2) supervise the juniors more closely to avoid lost motion; (3) complete the internal control questionnaire early in the audit rather than as a last minute "clean-up" job.

**Coming Soon**

The Institute announces that publication of its restatement and revision of the *Accounting Research Bulletins* is scheduled for the Summer of 1953.[20]

**Prediction**

This column predicts the issuance in this country, in the not distant future, of certificates as Industrial Accountant, Managerial Accountant, or Industrial Cost Accountant, or some equivalent. There is an ever-growing body of cost and management accountants, engaged in internal accounting work, and not interested in public practice, whose skills warrant and will obtain such recognition.

**Accountants' "Canned" Newsletters**

All accountants are familiar with the bulletins on tax rates, rules, and decisions prepared by publishing companies for use by accountants and business-

[17] January 1953, p. 70.
[18] Vol. XXII, No. 9, September 1952, pp. 33-48.
[19] *The Indiana Certified Public Accountant,* November 1952, p. 4.
[20] American Institute of Accountants *Newsletter,* Vol. 4, No. 1, January 1953, p. 2.

men. Some accountants imprint their names on the material and send it to clients.

While not generally in violation of the rules against solicitation and advertising—as long as the distribution is to clients only—this is a violation of the spirit of the rules of professional conduct, observes the editor of the *Virginia Accountant*:[21] "Bulletins of this type fall in the same category as calendars, mechanical pencils and book matches."

Concern is expressed lest a loss of prestige be suffered by the professional accountant who "allows his name to appear on publications which create the impression of solicitation." If a client requests a digest of the tax laws each year a copy not bearing the accountant's name "should serve as well."

### Optimism

Here is a quotation from an advertisement of the American Mutual Liability Insurance Company in the *Harvard Business Review*,[22] headed "Why Be Suspicious of Employees?" The ad reads, in part: "After an exhaustive *3-year study* of every kind of crime from stealing stamps to forgery, we've learned that in most cases they can be eliminated by the simplest minor changes in routine!"

### FIFO, LIFO, NIFO, and SASO

To the inventory valuation methods called FIFO, LIFO, and NIFO, a British accountant adds "SASO," which he describes as a method "where the businessman thinks of a value and selects it by his own say so, without any regard to principles or their consistent application."[23]

At a dinner in Liverpool in December, 1952, Mr. T. B. Robson, President of the Institute of Chartered Accountants in England and Wales, observed: "As accountants and . . . auditors we must set our faces steadfastly against its use and ensure that as far as practical the accounts with which we deal are based on stock valuations which result from the consistent application of recognized principles."

### Professional Oath

Kentucky is the only state which requires an oath by newly-admitted CPAs to "uphold [the] honor and dignity of the profession."[24]

### How Many CPA's?

As of August 31, 1952, just under 45,000, estimates the Institute.[25] The total of 44,761 reached by the Institute is made up of 44,128 in the United States and 633 in the territories and foreign countries.

Of those resident here, about 26,000 are members of state societies; about 20,000, Institute members.

### Oh! for only *Decent* Decisions!

Reporting the plans for "this year's tax conference sponsored by the University of Oklahoma" the *Oklahoma Certified Public Accountant*[26] observes: "Discussions of the tax aspects of depreciation and depletion, unitization agreements, carried interest agreements, *decent* (for *recent*) decisions affecting the industry and other topics are scheduled from Thursday afternoon. . . ."

### Check the Definition of Small Business

What you consider a large client, the government may dub "small business". That term is used loosely; is defined differently by various government agencies.

A recent news item in *The New York Times*[27] reports comments by Casper

21 Vol. VI, No. 3, January 1953, p. 3.
22 Vol. XXX, No. 1, January-February 1952, p. 19.
23 *The Accountant*, Vol. CXXVIII, No. 4072, January 3, 1953, p. 25.
24 *The CPA* (American Institute of Accountants membership bulletin), December 1952, p. 13.
25 *Ibid.*, p. 15.
26 October 1952, p. 6.
27 December 9, 1952.

H. Citron, Regional Director of the Small Defense Plants Administration, on rapid tax amortization. In the metal can industry, "small business'" share has been set at 13 per cent of the $31 million in capital investment authorized as eligible for rapid tax amortization. The item notes further: "For the program's purpose small concerns have been defined as those with 1,000 employees or fewer."

**Irish Accounting Examinations**

Reminiscent of our problems in accountancy training is this foreign note. Half the candidates for each professional accountancy examination fail to pass, points out the *Irish Accountant and Secretary*.[28] The reasons? Among others—too many candidates who have not completed the course of study; too low a "standard of education amongst recruits for articles."

"We do not consider that Accountancy examinations are too difficult," observes the journal, "although students seem appalled by the wide scope of the questions."

The requisites for success in the examination?—"Hard Work, conscientious application to studies, and good health."

**Confiscation—and a Tribute to Accountancy**

Burdensome as is our tax situation, it has not reached the state reflected in this Australian report:[29]

> "In one income year, that ending on 30 June 1941, the then Government was so overcome by war hysteria that income taxes were considerably in excess of 20s [shillings], in the £. At that time in Western Australia, an individual with an income of £2,300 had left after payment of income taxes £1,028. Thereafter his residual income steadily decreased, until with a taxable income of £5,725 he had left an amount of £572, or 10% of his taxable income! Not until a taxable income of £10,250 was reached did a taxpayer have as much left after payment of tax as he would have had if his income had been only £2,300.
>
> "Many taxpayers, who are able to do so, entirely ceased operations in the latter quarter of the financial year, as by refusing to earn income they actually saved money!
>
> "Fortunately the Gilbertian situation only obtained for one year, but . . . it . . . could not have happened if there had been . . . seeking of advice by the Government from the accountancy profession . . ."

**Here, too**

From *Indian Taxation* (published in Delhi):[30] "Though the Government's voluntary income disclosure scheme was officially terminated on October 22 [1951], assessees are still offering to disclose their concealed wealth."

**Trends in Financial Statement Presentation**

The sixth annual cumulative survey of the accounting aspects of 600 corporate annual reports, supplemented by comments on unusual accounting treatments in some 700 additional reports—the annual survey prepared by the research department of the American Institute of Accountants—again provides many interesting facts concerning current accounting trends and techniques in statement presentation.[31]

*Pennies Are Dropped*

There is a marked tendency towards the omitting of cents from financial statements[32] included in the published annual reports to stockholders.

While in 1946 just over 40% of the companies omitted *cents* from the statements, by 1951 this proportion had increased to approximately 75%[33].

*Renegotiation Refunds*

199 companies, or just under one-third of the 600 included in the 1952

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[28] Vol. 17, No. 11, November 1952, p. 161.

[29] *Australian Accountant*, Vol. XXII, No. 11, November 1952, p. 390.

[30] Vol. III, No. 2, February 1952, p. 67.

[31] American Institute of Accountants, Research Department, *Accounting Trends and Techniques in Published Corporate Annual Reports*, 6th Ed., November 1952.

[32] *Ibid.*, p. 9.

[33] Based on Table 5, p. 10.

current survey, referred to renegotiation proceedings. 154 (about three-quarters) of these reported that no provision for renegotiation was needed[34].

*Certificates of Necessity*

152 (of the 600 companies under review) reported that they had obtained Certificates of Necessity in the year under review or in earlier ones[35].

*Inventories*[36]

*Valuation:* As might be expected, the most common valuation basis employed was the lower of cost or market (468 of 778 references to inventory valuation indicated the use of this basis. This represented 60 per cent); *Cost* followed, with 219 of 778 statements—or 28 per cent; *Cost or less than cost*, and the same description, with the added words *"not in excess of market"*, 45 or 6 per cent; *Market Value*—27 companies; *Assigned Value*—4 companies; *Various other bases*—15 companies.

Only 1% of the companies (6 in all, of 600) failed to state the basis of valuation.

*Overhead Omitted:* In a footnote to its Balance Sheet, one company[37] reported the omission of overhead from costs, in valuing the inventory. The company commented: "such omission, although conservative, is not recognized as being in conformity with generally accepted accounting practice".[38]

At the date of the last physical inventory overhead represented about 22% of the prime cost; the total overhead was about 3½ million dollars. As to the effect on the income statement: had overhead been included in both opening and closing inventories, net income for the year would have been about $110,000.00 greater.

*LIFO:* The number of companies using the LIFO basis of determining inventory cost rose from 115 (of 600 under review) in 1949 to 183 (of the same total).[39] This brought to approximately 30 per cent the number using LIFO.

A table is furnished showing the specific companies which used LIFO in 1949, 1950, and 1951,[40] arranged by industry.

## Natural Business Year

The Maryland Association of Certified Public Accountants' *CPA News Bulletin* contains an account of how a canning factory's financial position was improved through the medium of shifting the year-end closing date.[41]

Formerly the company closed its books at December 31. There was a "time-consuming job" taking physical inventory, reports were delayed, and the year-end results always included "a mixture of the tag-end results of one season's operations and the initial results of the new season."

By shifting the year-end date to April 30, the end of the natural business year, the company was in better position to plan operation for the coming season. Further, the bank saw the statements at a time when working capital was not tied up in inventory. The client was well satisfied; it had "eliminated the fumbling for time and money" that existed when the company operated on a calendar year basis.

The Maryland association presents a list of suggested fiscal year closing dates, prepared by Dun and Bradstreet, Inc.

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34 P. 44.

35 P. 47.

36 P. 58.

37 E. R. Squibb and Sons.

38 P. 59.

39 P. 65.

40 Table 8, p. 69.

41 Vol. 3, No. 4, January 1952, pp. 3-4 (based upon an Illinois Society of CPAs bulletin).

### The Controller in Fiction

Have you read Cameron Hawley's "Executive Suite"?[42] It depicts the struggle among the five major executives of a furniture manufacturing corporation for the presidency of the company following the sudden death of the head of the concern. One contestant was the controller, " a specialist in industrial management, a man of enormous confidence, who foresaw every detail." The other contenders for the top post were the sales manager, the treasurer, the head of the manufacturing division, and the chief of design and development.

The controller's view was: "by the time you get to the presidential level the emphasis must be predominately financial".[43] He illustrated his work: "over the past year I've devoted a substantial amount of time to the development of a new relationship between the parent company and some of our wholly owned subsidiaries in order to give us a more favorable tax situation . . . that one piece of work, all purely financial in character, will contribute more to our net earnings than the total profit we'll make from one of our smaller factories."[44]

The controller did not get the presidency. After the contest was over, the winner said of the controller: ". . . capable man . . . Not too much imagination, perhaps—but sometimes that's an asset. . . . I'll need somebody to help me keep my feet on the ground."[45]

### Professional Courtesy

The *CPA Newsletter* of the California Society of CPAs discusses[46] several informal rules covering relations between practitioners when clients contemplate a change of accountants.

*New clients:* The best practice, observes the Chairman of a Committee on Professional Conduct, is to limit the first interview with the prospective client to a discussion of the scope of the engagement. Then the accountant should get in touch with the present accountant and tell him that he has been invited to take over the engagement. Following this discussion, if the new accountant is still interested, it would be appropriate to discuss the matter of fees and related arrangements with the prospective client.

*Unpaid fees:* It is suggested that the accountant inquire whether any fees are still due his predecessor. If the answer is yes, it might be suggested that settlement of the account be effected before the new accountant takes over the engagement: "if you have ever been on the wrong end of one of these situations you will appreciate the merits of this method of clearing up any fees due you."

*Work papers:* The accountant could not properly make his permanent file data and related working papers available to a successor unless he were furnished with a letter of authorization signed by the client. To do otherwise would be a violation of the confidential relationship with the client.

### Accountancy for the Young

*Fraud Reaches the Nursery*

Accountancy has found its way to the nursery. A story in *Children's Digest*[47] reports the difficulties of King Renwick the Fourteenth with his Chancellor. Before the problems arose, the King had said, "Isn't it lucky . . . that my chancellors have all been excellent mathematicians? This last . . . one is a jewel. You ought to see the way he

(Continued on page 280)

[42] Houghton Mifflin, 1952, 346 pp., $3.00; published simultaneously by Ballantine Books, Inc., paper-bound, 35 cents. Cameron Hawley has had considerable business experience. Until recently, he was advertising director of the Armstrong Cork Corporation.

[43] P. 327.

[44] P. 328.

[45] P. 346.

[46] Vol. 6, No. 6, January 1953, p. 2.

[47] Palmer, Robin, "Sing a Song of Sixpence," Vol. III, No. 24, January 1953, pp. 26-35.

# The School of Commerce, Accounts, and Finance of New York University

## —Its Promotion and Organization

Prior to 1893, the only opportunities open to those who desired to prepare for service as bookkeepers or accountants were work under those who were experienced in those occupations, or the course of study and practice available in many business colleges. That both these ways were useful is evidenced by the many successful men who had acquired their training in one or both ways.

But those in the public practice of accountancy wanted something more, apparently for one or both of two reasons. Many, probably a majority, desired something which would widen and elevate the public understanding of their occupation, then not generally recognized as a profession. One or more methods for this purpose were proposed to the American Association of Public Accountants which had been organized during the winter of 1886-1887, but the methods had not been adopted or had not been successful.

Late in 1891, that Association suddenly had accessions which increased its membership nearly one-half. No explanation was published or even recorded before or while that growth took place. It can be surmised only by the outcome of that growth.

One of the new members was Henry R. M. Cook, who for some years had been with the Board of Education of New York City. At once he was elected to the Council and appointed chairman of a newly formed committee which at first was known as Special Committee.

> This is the eleventh in a series of articles on the History of Accounting in the State of New York. It was prepared by the Society's Committee on History.

But by February 6, 1892, it was called the Committee on Charter, and its activities and aims were made known.

This disclosed the second reason why something more was wanted. Some influential practitioners wanted not only a more general recognition of the profession but also a greater supply of well-trained assistants. To supply those needs the Association sought and obtained from the Regents of the State of New York a two-year charter for the New York School of Accounts.

By the fall of 1893 that School was organized with a Board of Trustees composed of about an equal number of prominent business men and public accountants; with a faculty composed exclusively of accountants in practice except that commercial law was taught by John L. N. Hunt, Esq., of the New York City Board of Education; and with the provision of rooms, furniture, etc., for its activities.

The School was conducted during only the one year, 1893-1894. Its faculty and trustees considered that it was a failure. Absence from the city of the regular teachers had made it necessary to get substitutes probably less well prepared, and only seven students had taken the whole course. While that was discouraging, the teachers could not know that of the five students whose names are known, three would enter upon public practice and two of them become CPA's and members of State Societies. An effort was made to have Columbia University take over the School but that attempt was not successful.

The next effort to provide education for accountancy was after the CPA Law was enacted in 1896. This effort was by Theodore G. C. F. Koehler as told in the December, 1949, issue of

*The New York CPA* (v19, p735) who gave it the same name as the earlier one, The New York School of Accounts. But this private institution did not meet the desires of those who wanted public recognition of the importance of the profession.

Here Henry R. M. Cook, who had initiated the movement for the first New York School of Accounts, again came into the picture. At a meeting of the State Society on November 13, 1899, he offered a resolution as follows:

> "Whereas it is the sense of this Society that it is expedient and necessary to the development of the profession of Public Accountancy that the same be established upon an educational basis, as in the case of other professions; and that means should be taken to render the proposition effective, therefore
>
> Resolved, that the President be and he is hereby requested to confer with the Trustees of Columbia University or the University of the City of New York, or other collegiate body with the object of effecting an arrangement for the establishment of a class, and for a technical course of study therein, in the science of accounts, finance and economy, business practice, commercial law and such other subjects necessary to the special education of persons desiring to enter the profession and to become Certified Public Accountants.
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> Resolved, that the President be empowered in his discretion to invite the cooperation of kindred societies in this State and of members of the profession interested in the future success of accountancy; to the end that strong effort be made to effectuate the objects of these Resolutions and thereby strengthen the profession."

The foregoing preamble and resolutions are here quoted from pages 21-22 of the Ten Year Book, 1897-1906, which also shows that they were adopted. While not so stated it is probable that they had been approved by the Directors.

At the next meeting of the Society on December 11, 1899, the record was:

> "The President reported that in accordance with the resolution passed at the last meeting he had conferred with the heads of the two universities.
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> President Low of Columbia had suggested that a curriculum be prepared which would be available in the proposed special course in Finance as outlined by the Chamber of Commerce.
>
> Chancellor MacCracken of New York University had asked that the proposal be outlined more fully which had been done in a letter dated December 11."

The Society ordered that the letter be entered in full in its minutes. Later it was printed on pages 23-25 of the Ten Year Book, but too long to be quoted here.

At that meeting also the Society approved the Presidents' action and authorized a special committee of five to be known as the Conference Committee on University; and to be empowered to confer with the Universities with a view to the establishment of a School of Accounts. This committee consisted of Henry R. M. Cook, chairman, C. W. Haskins, J. R. Loomis, A. O. Kittridge and Leon Brummer.

Thereafter no mention of the matter was made in the Society minutes until October 7, 1900, when reports were received from Chairman Cook and President Haskins, both showing that the desired result had been attained. But during the intervening ten months there must have been conferences and correspondence as to the scope and details of the curriculum, the hours to be given to each subject, the selection of the faculty, the fees for tuition and many minor though important details. Almost surely records had been made of those actions. But recently no such records could be found at the office of the State Society or at the University and both Cook and Haskins were deceased. Inquiries at many places finally developed the fact that there had been such records and probably what had become of them.

It was learned that while Charles Waldo Haskins was working upon the organization of the School he had used as his secretary for that work Emory J. Banta, perhaps 45 years of age who though educated as a lawyer was not in practice. The only one who remembered him and his service with Haskins was Howard B. Cook, but he did not

know what had become of Banta or what disposition had been made of his files.

But it was found that some years after Haskins' death, Banta had wished to dispose of his files on this matter and had given them to a friend, Herbert F. Vaughan, a graduate of the School in 1906. But Vaughan died in 1932 and his widow not knowing of anyone who might use them had carted away as rubbish a trunkful of Banta's papers including correspondence, memoranda, addresses, etc., of Mr. Haskins. The authority for this account of their disposal is an oral statement by Mrs. Vaughan to her brother, Henry A. Horne. Since all members of the Committee have died it is probable that the details of their actions prior to June 25, 1900, may never be learned.

But without knowing what had gone before there is a record of what had been accomplished before or by June 25, 1900, when the Committee submitted to the Trustees of New York University its proposed curriculum and other details including its pledge to provide a faculty for the course, all as shown on pages 28-33 of the Society's Ten Year Book.

The University as represented by a Committee appointed with power decided on July 28, 1900, to incorporate the proposed school. And on October 1st the School of Commerce, Accounts and Finance commenced operation with a faculty provided as follows:

Although the State Society's interest in the School continued as evidenced by its gifts of funds for the School's library and by its many members who served the School as professors, instructors or lecturers, probably its greatest contribution to the School was its effort to promote and establish the School as here briefly recited.

As previously stated herein none of these details were found in the records at the University. However confirmation of the Society's initiation of the project was given in "New York University: 1832-1932" which on page 356 stated:

> "The New York State Society of Certified Public Accountants deserves the credit for conceiving the idea of the School and shaping the plan; Chancellor MacCracken deserves almost equal credit for being broad-minded and far-sighted enough to admit this new and experimental School into full fellowship with the old and successful Schools of the University. There was no endowment; he merely had the assurance of the sponsors that no deficit would result. * * *
>
> "In 1900, however, the idea of professional training for business was generally looked upon with skepticism, if not with actual derision, not only in academic but in business circles. Fortunately, the men who approached Chancellor MacCracken were men of high character and deep sincerity, whose business success was proof that they were not visionaries."

By the University—

| | |
|---|---|
| Chancellor | Henry M. McCracken DD, LLD |
| Commercial Law | Various professors of the Law School for the subjects of Trusts, Finance, Sales & Agency, Partnership, Bills & Notes, Insurance, etc. |

By the State Society—

| | |
|---|---|
| Dean | Charles Waldo Haskins CPA |
| History of Accountancy | Charles Waldo Haskins CPA |
| Auditing | Charles Waldo Haskins CPA, and Ferdinand W. Lafrentz CPA |
| Theory of Accounts | Charles Ezra Sprague MA, PhD, CPA, and Anson O. Kittridge CPA |
| Practical Accounting | Henry R. M. Cook CPA, and Leon Brummer CPA |

# The 114th New York Certified Public Accountant Examination

**November 5, 6 and 7, 1952**

## THEORY OF ACCOUNTS

**Friday,** November 7, 1952—1.30 to 5 p. m., only

**This paper is intended to test the extent of your knowledge of accounting theory and your ability to apply the knowledge you have acquired. Due weight will be given to the arguments presented to support your answer to each question, even though the examiners may not agree with your conclusions.**

**Answer questions 1 through 6 and any two of the last three questions.**

1 [10]

Austin and Bradford are partners. They share profits equally and have equal investments. The partnership's net assets are carried on the books at $20,000. Crane is admitted to the partnership with a one-third interest in profits and net assets. Crane pays $9,000 cash into the partnership for his interest.

Prepare journal entries to show three possible methods of recording on the partnership books the admission of Crane. State the conditions under which each method would be appropriate.

2 [10]

Corporations frequently establish a minimum dollar amount for items to be capitalized as fixed assets. The minimum may be as low as one dollar or as high as several hundred dollars. Regardless of nature, all expenditures for initial installations amounting to less than this established minimum are charged to current expense.

What factors should be considered by a corporation in establishing the amount of such a minimum? Explain why each factor should be considered.

3 [10]

Some manufacturing businesses identify or allocate all manufacturing overhead to productive departments. An overhead rate then may be established for each productive department based on direct labor cost. Using this rate, overhead is then applied to jobs or products.

Discuss the possible advantages and disadvantages of the direct labor cost basis for applying overhead to jobs or products as opposed to other commonly used bases for overhead distribution, such as machine hours or cost of material used.

4 [12½]

*a* State the rules dealing with the recognition in financial statements of purchase commitments and expected losses on commitments.

*b* The Robcay Corporation has a fiscal year ending June 30. At June 30, 1952, it has purchase commitments for which the market price is less than the contract price and for which there is a probable loss based on current resale price.

(1) At June 30, 1952, what entry can be made by the Robcay Corporation to reflect the market decline?

(2) Describe how the accounts involved in your answer to *b*(1) should be shown in the financal statements. Justify the balance-sheet treatment you describe.

(3) What entry should be made when the goods are received in November 1952?

5 [15]

A small motor trucking corporation purchased two new trailers on September 30, 1952. The purchase contract specified a total price of $15,752 and a down payment of $5,000. The balance was covered by a non-interest-bearing installment note to be paid in 24 monthly installments of $448. The first payment was due on October 31, 1952. Included in the total price was an interest and finance charge of $1,152.

The purchase was recorded by the following entry:

| | | |
|---|---|---|
| Trailers | $14,600 | |
| Deferred interest and finance charge | 1,152 | |
| Cash | | $ 5,000 |
| Installment note payable | | 10,752 |

*a* In journal entry form, record the October 31, 1952, payment and adjustment of the deferred interest and finance charge account. Use the straight-line method of amortization.

*b* Give arguments for and against the straight-line method of amortizing the deferred interest.

*c* The corporation wishes to show the deferred interest as a deduction from the installment note payable on its balance sheet. Give arguments for and against this treatment.

6 [12½]

You have a client who is considering making a long-term personal investment in common stock of a manufacturing company. The published financial reports of the company for the past two years have been reviewed by him. These reports seem to have been prepared in the usual manner. The balance sheets show that the company has substantial inventories and a large investment in fixed assets.

Prepare a report for your client setting forth the limitations to forming an opinion for investment purposes inherent in a review of such statements standing alone. Indicate other factors to be considered in making long-term stock investments.

**Answer any two of the following three questions.**

7 [15]

The Montan Corporation operates a copper mine and smelting plant. It has recently hired a new controller. He finds that inventory is valued at cost and that depletion is calculated on the basis of tons of ore extracted and is charged to production. The new controller agrees that inventory should be valued at cost and he agrees that depletion should be calculated in the manner stated above. He proposes, however, that depletion should not be recorded until the refined copper is sold, at which time it should be recorded as a separate charge to cost of goods sold.

*a* If the controller's proposal were adopted, describe in detail its effect on subsequent income statements.

*b* If the controller's proposal were adopted, describe in detail its effect on subsequent balance sheets.

*c* Give arguments for and against the controller's proposal.

8 [15]

The X Corporation entered into an agreement with certain of its officers whereby options to purchase the corporation's common stock at a fixed price, substantially below current market, will be granted to them at the completion of certain periods of service. The agreement specified the date on which the options will be granted, the periods of service to be performed, the period during which the options are valid as well as the price and amount of stock to be covered by each officer's option.

You are to discuss the following two accounting questions arising out of these agreements:

*a* The date on which the compensation represented by these options should be considered to require recognition from the standpoint of the company. The following three dates have been advanced as possibilities and each of them should be considered in your answer: (1) the date of the agreement, (2) the date on which the services are completed and the option rights become the property of the officers, (3) the date(s) on which the options are exercised.

*b* What should be the basis of computation of the amount to be recorded as compensation? Include in your answer an explanation of your reasons for the basis proposed.

9 [15]

*a* The excess profits tax law provides two general alternative methods of computing the excess profits credit. They are commonly referred to as (1) "income method" and (2) "invested capital method" with various further alternatives available under each of the two general methods.

Assuming that taxpayer is on a calendar-year basis, group the following items into categories which affect the computation of the excess profits tax for 1952 under (1) the income method exclusively, (2) the invested capital method exclusively, (3) both methods:

(*a*) notes receivable from a wholy owned subsidiary
(*b*) interest rates on borrowed capital outstanding at January 1, 1948
(*c*) distributions to stockholders during the first 60 days of the calendar year 1952
(*d*) introduction of a new product
(*e*) borrowed capital outstanding at January 1, 1949
(*f*) equity capital at January 1, 1952
(*g*) average borrowed capital for the calendar year 1952
(*h*) comparison of payrolls
(*i*) distribution during the first 60 days of the calendar year 1949
(*j*) aggregate of the net operating losses over aggregate of the net income for the years 1940 through 1949

*b* A corporation has normal tax net income in 1952 in the amount of $900,000. Its excess profits credit is $650,000 under the income method and $675,000 under the invested capital method. The corporation's borrowed capital consists of a $1,000,000, 5% long-term loan, which has remained unchanged from January 1, 1950, through December 31, 1952. Based on the foregoing facts, which excess profits credit should be used in computing excess profits tax payable on 1952 income? Explain your conclusion.

## COMMERCIAL LAW

**Friday,** November 7, 1952—9 a. m. to 12.30 p. m., only

**Reasons must be stated for each answer except for objective type questions; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.**

*Answer the questions as directed under each group. Papers entitled to 75 or more credits will be accepted. Figures in brackets indicate the number of credits allowed.*

**Group I—Answer all questions in this group.**

1 [10]

M bought a suit of clothes from A for $65. In payment, M signed a check in blank on D Bank and gave it to A instructing A to complete the check for $65. A completed the check to his own order for $165, indorsed it with a special indorsement and sold it to B, a holder in due course. B in turn negotiated the check to C in payment of an account. C, who was unaware of the circumstances of the check's completion, acquired the check within a reasonable time after M had given it to A, but B neglected to indorse the check. C presented the check properly to D Bank which refused to pay it because the bank had made an error in computing M's balance which showed insufficient funds to cover the amount of the check. C immediately sent proper notice of dishonor to M.

Give reasons for your answer to each of the following questions:

*a* If B had retained the check, could he have recovered $165 from M, assuming proper presentment, dishonor and notice of dishonor to M?

*b* May C recover $165 from M?

*c* May C recover $165 from D Bank?

2 [10]

A owed $1,000 to C, a common carrier of goods, for C's transportation of A's automobile. A subsequently delivered a truck to C for transportation to X City, receiving from C a negotiable bill of lading in A's name. A indorsed, sold and delivered the bill of lading to B who paid A $5,000 for it. The transportation charges on the truck to X City were $200.

*a* For how much does C have a lien on the truck? Explain.

*b* If B tendered the bill of lading and $200 to C, and C refused to accept them, could B compel C to deliver the truck to him? Explain.

*c* If the bill of lading were non-negotiable and C, ignorant of A's transfer of the bill of lading to B, delivered the truck to A without obtaining the bill of lading, would B have any rights against C? Explain.

3 [10]

A offered by mail to sell B his farm for $10,000. A's letter was mailed on July 5 and received by B on July 8.

*a* Assume that B wrote A on July 9, inquiring: "Won't you take less?" A replied by letter on July 13, "No." B then mailed a letter to A on July 17, stating, "I accept your offer of July 5." A refused to have any further dealings with B. Assuming that July 17 was a reasonable time within which to have replied to the offer of July 5, is there a valid contract between A and B for the sale of the farm? Explain.

*b* Assume that B, on July 10, sent a telegram to A in which he accepted the offer of July 5. A never received the telegram. Would a valid contract have been formed between A and B for the sale of the farm? Give reasons for your answer.

*c* Assume that A had intended to ask $10,500 for the farm but inadvertently used the $10,000 figure in his letter. B accepted the offer but A refused to sell for less than $10,500. Is B entitled to enforce the contract for $10,000? Explain.

*d* Assume that B was not interested in A's offer and gave A's letter to C telling C to accept if he were interested. C sent a letter to A in which he said, "I accept your offer." A refused to convey the land to C. May C recover from A for breach of contract? Why?

4 [10]

*a* Name three acts which, under the Uniform Partnership Act, require the unanimous consent of all of the partners in order that such acts be binding on the firm.

*b* State the order in which partnership assets are distributed if the partnership is dissolved voluntarily.

*c* Name three ways in which a partnership can be dissolved by the act of a partner, or partners, without violation of the partnership agreement.

*d* If a court has possession of both partnership property and the individual properties of the partners, how will the properties be distributed as to the partnership creditors and creditors of the individual partners?

5 [10]

*a* The Board of Directors of X Corporation has entered into a contract with T, an individual. The contract is ultra vires the corporation. Which, if any, of the following parties may legally object to the ultra vires act: (1) the state of incorporation, (2) a stockholder in X Corporation, (3) Y Corporation, a competitor of X? Explain.

*b* Assume that the ultra vires contract in *a* above is performed in full. T now wishes to return the consideration he received and get back the consideration he had given. Should a court give him this relief? Why?

*c* At a directors' meeting, attended by the five directors of L Corporation, a contract was voted on favorably by three members. If the contract was between L Corporation and B, one of the directors who voted for the contract, can the contract be avoided by the corporation? Explain.

**Group II—Answer any five questions in this group.**

6 [10]

*a* Name *four* duties or obligations of a principal to his agent.

*b* What is an agent's lien? To what funds or property of the principal does an agent's lien attach?

*c* Is the relationship of a public accountant to his clients that of an independent contractor or that of an employee? Explain.

7 [10]

A agreed in a written contract to erect for O an apartment building according to plans and specifications for a contract price of $100,000. For each of the following cases, state whether A's non-performance would be excused. Give a brief reason for each answer.

*a* A becomes paralyzed and bedridden as a result of an accident.

*b* A refuses to complete the building because construction and labor costs have risen 25% since the contract was made.

*c* Because of possible war with a foreign power, Congress has passed a law forbidding the construction of such buildings.

*d* O becomes bankrupt and will be unable to pay for the building when it is completed.

8 [10]

*a* A bought a floor lamp from B and paid $25, the purchase price of the lamp, to B. A had other shopping to do and asked B to allow him to leave the lamp in B's store until he returned for it. B agreed to this request and placed a "Sold" tag on the lamp. The tag fell off and T, a clerk in B's store, sold the lamp to X, who paid for it and took it with him when he left the store. T and X were unaware of the previous sale to A. Has A or X the better right to the lamp? Why?

*b* D, another customer of B, under agreement with B, took a chair home from B's store. D was to use the chair for one week and then either return it to the store or pay $75 to B. Ten days later D's home and its contents, including the chair, were destroyed by fire. Upon whom, B or D, does the loss of the chair fall? Explain.

9 [10]

*a* State the respects in which joint-stock associations at common law differ from corporations and the respects in which they resemble corporations.

*b* Define *each* of the following types of corporation: (1) municipal, (2) quasi.

*c* Distinguish between domestic and foreign corporations.

*d* When does a corporation become bound by the agreements of a promoter relating to its formation?

10 [10]

*a* What requirements must one satisfy to become a holder in due course of a negotiable instrument?

*b* What is "protest"? When must it be used?

*c* What is the major legal advantage of a certified check as contrasted with one which is not certified?

*d* Before the indorsers on a negotiable instrument can be held, in event of non-payment by the maker, what steps must the holder take?

*e* Upon what date should you present for payment the following negotiable instruments: (1) one which matures on Tuesday, June 5, (2) one which matures on Wednesday, December 25, (3) one which matures on Friday, July 4?

11 [10]

In *each* of the following statements, the blank indicates the omission of a word or phrase. You are to select the word or phrase, from those at the end of each item, which most appropriately completes the statement. Indicate your choice by listing the numbers 1 through 10 on your answer paper and by placing the letter (a) or (b) beside the appropriate item number. Grade will be based on the number of correct answers. No reasons need be given to support your choice.

(1) A deed conveying real property . . . be recorded to be valid as between the grantor and grantee. (a) must (b) need not

(2) The grantee's name in a deed purporting to convey real property is misspelled. This . . . invalidate the deed. (a) does not (b) does

(3) A deed, purporting to convey real property, recites a consideration of $10.00. No money was actually paid. The deed . . . valid. (a) is (b) is not

(4) A deed, purporting to convey real property, contains no date. This . . . the deed from being valid. (a) prevents (b) does not prevent

(5) Failure to attach the necessary Federal Revenue Stamps to a deed . . . the deed. (a) invalidates (b) does not invalidate

(6) A deed to be effective as a conveyance of real property . . . be delivered. (a) must (b) need not

(7) An individual, having acquired legal title to land through adverse possession, deeds the property to another. Good title . . . conveyed. (a) is (b) is not

(8) A deed is made purporting to convey the title to real property to an infant. The deed is . . . (a) void (b) valid

(9) A parcel of land is conveyed by a warranty deed. There is a recorded, unpaid mortgage on the land. No mention of the mortgage is made in the deed. The grantor . . . breached a warranty. (a) has (b) has not

(10) A quitclaim deed is made by a grantor to a grantee. It later is found that the grantor has no interest in the land described in the deed. The grantee . . . recover for breach of warranty from the grantor. (a) can (b) can not

12 [10]

Below are ten statements. On your answer paper you are to write the numbers 1 through 10. Opposite each number you are to write the word "true" if the statement is true and the word "false" if the statement is not true. Grade will be based on the number of correct answers. No reasons need be given.

(1) No person can be forced into involuntary bankruptcy unless he is insolvent.

(2) No person can be forced into involuntary bankruptcy because of an intentional preferential transfer while insolvent if he is solvent again at the date the petition is filed.

(3) A $50,000 gift given to a bankrupt by his father three weeks after the petition in bankruptcy was filed becomes part of the old bankrupt estate available for creditors.

(4) An ordinary judgment lien only three months old when a petition in bankruptcy is filed against the debtor is no longer enforceable as a lien, if at the time when such lien was obtained the debtor was insolvent.

(5) The referee in bankruptcy is the person who takes title to the bankrupt's property.

(6) Taxes, other than property taxes, are paid out of the bankrupt's estate before wages are paid.

(7) Wages, without limit as to amount, if earned within three months immediately prior to bankruptcy of the debtor, carry over against the bankrupt's new estate if they are not paid in the bankruptcy proceeding.

(8) In bankruptcy, wage claims are paid out of validly mortaged property before the mortgage debt.

(9) A discharge in bankruptcy does not relieve the bankrupt debtor of liability for money borrowed as a result of the debtor intentionally misrepresenting his financial condition.

(10) A person may not be forced into bankruptcy more often than once every six years.

*The 114th New York Certified Public Accountant Examination*

## AUDITING

**Thursday,** November 6, 1952—9 a. m. to 12.30 p. m., only

**Write your answer clearly and concisely, being particular to express your own knowledge, for on that is based the rating. Avoid quotations from authors. Credit will be allowed not only for accuracy of answer but also for technic.**

*Papers entitled to 75 or more credits will be accepted. Figures in brackets indicate the number of credits allowed.*

**Answer all questions.**

1 [12]

You are making a regular annual audit of a small, but growing, manufacturing corporation. As a result of inadequate working capital, the corporation has borrowed from its bank on short-term notes and has occasionally given notes to suppliers for overdue accounts payable.

In outline form, prepare an audit program for notes payable.

2 [12]

Your client is a small, closely-held manufacturing corporation. A full-time bookkeeper keeps all the records and prepares monthly statements. You are retained to make a year-end audit which your client states will be used only by management.

Perpetual inventories are not maintained. Management plans and supervises the physical inventory and sees no need for you to observe the taking of the inventory or for you to test the inventory quantities. As a matter of customer relations, management believes that you should not confirm receivables. Accordingly, the terms of your engagement call for a regular annual audit except that you do not confirm receivables, observe the physical inventory, or make test counts of inventory.

In the course of your audit, you find no exceptions to the consistent use of acceptable accounting procedures or conventions.

*a* Draft a short-form audit report to be submitted for this engagement.

*b* Explain fully why your short-form audit report varies or does not vary from the usual form.

3 [15]

A suburban hospital is planning a drive for contributions to a construction fund. Solicitation will be by mail and by personal appeals made by volunteer workers.

What controls would you suggest over the receiving of contributions? As to each control, include a brief statement of its specific purpose.

4 [12]

Assume that you are the senior in charge of the audit in *each* of the following cases:

*a* You go to the client's receiving department office to count an imprest petty cash fund of $15. The custodian goes to the next room to get the petty cash box and you hear him say, "Hey, Joe, give me $10 for petty cash, the auditor is here." What action would you take? Explain.

*b* You are reviewing a client's entries for prepaid insurance and insurance expense. The largest policy was purchased during the year under audit, and you find that the client has charged 27 months premium to expense and set up 9 months premium as prepaid. You calculate that 9 months premium should be charged to expense and that 27 months premium should be set up as prepaid. What should be done? Give the reasons for your answer.

*c* You are on the audit of a medium-sized manufacturing company and are working on a table in the treasurer's office. The treasurer has sole control over cash receipts and disbursements. While you are working on cash, the treasurer seems to be watching you and several times asks if he can be of any assitance. You find that the cash receipts book has been underfooted and that several receipts have not been deposited. What action would you take? Give reasons to support your answer.

5 [12]

List and briefly describe the procedures by which an auditor who is making a regular annual audit might discover unrecorded liabilities.

6 [15]

Your client, the Morgan Co., manufactures baby carriages as its only product. It maintains perpetual inventory records in quantities and values and also takes a complete physical inventory each October 31st.

You are assigned on September 12th to review the client's written plans, procedures and instructions for taking the physical inventory. What are the principal points for which you should look? Give your reasons for their inclusion.

7 [12]

In previous years you have been assigned to the audit of a beverage manufacturer as a junior and later as a semi-senior. This year you are assigned as senior in charge. You find a new account in the general ledger with the title "Formulas and Processes." This account has a debit balance of $25,000. You check back to the general journal and find the following entry:

| | | |
|---|---|---|
| Formulas and Processes ...................... | $25,000 | |
| Capital Stock .......................... | | $25,000 |
| To record issuance of stock at par to John Doe for secret formulas and processes which are not patentable. | | |

Describe the procedures you would follow in connection with this new account.

8 [10]

The following twenty statements are to be judged on the basis of whether or not they are basically true statements. Write on the left-hand side of a sheet of paper the numbers 1 through 20. Opposite the number, write the word "True" if you believe that the related statement is true. If the statement is not true, write the word "False." No reason need be given to support your answer. Your grade will be based solely on the number of items correctly answered.

(1) The American Institute of Accountants publishes a standard audit program and encourages its adoption for general use.

(2) An independent public accountant, in making an annual audit, should supervise and assume responsibility for the taking of a physical inventory by his client.

(3) The rules of professional conduct of the American Institute of Accountants prohibit a member from being an officer, director, or stockholder of a corporation engaged in the practice of public accounting in the United States.

(4) The fact that an auditor is unable to express an unqualified opinion clearly indicates that he has made an unsatisfactory audit.

(5) An independent public accountant usually completes his review of the system of internal control before he begins his audit.

(6) By tracing each entry in the general ledger to the books of original entry, the auditor establishes that all postings have been made to the ledger.

(7) The Securities and Exchange Commission publishes a check-off list of generally accepted accounting principles.

(8) The extent of auditing by an independent public accountant may be influenced properly by the extent of internal auditing.

(9) If footnotes to financial statements are not adequate, the auditor is obligated to clarify them in his report.

(10) The ordinary examination for the purpose of expressing an opinion respecting financial statements is not designed to disclose and cannot be relied upon to disclose defalcations.

(11) An auditor is under obligation to disclose certain transactions and events which occurred subsequent to the period under audit but before the audit was completed.

(12) It is acceptable procedure for an independent auditor to confirm accounts receivable as of some date other than the balance-sheet date.

(13) The short-form report must be qualified if there is a difference between net income shown by the books and net income shown on the federal income-tax return.

(14) Audit working papers are generally the property of the company whose records were audited.

(15) Oral information furnished by officers and employees of a client must not be considered as evidence by the auditor.

(16) A negative form of confirming accounts receivable is most appropriate where there are a large number of accounts having small balances.

(17) If the accounts receivable control exceeds the total of the subsidiary accounts and the error is not discovered, the control should be written down and accounts receivable on the balance sheet should be stated at the total of subsidiary balances.

(18) The Securities and Exchange Commission requires that all listed companies select their auditors at a stockholders' meeting.

(19) The most satisfactory method of determining audit fees is to set them at an agreed percentage of net profit because this measures ability to pay.

(20) It is common practice for an auditor to appraise physical property in a balance-sheet audit or in other audits where he must give an opinion on the balance sheet.

## PRACTICAL ACCOUNTING — Part I

**Wednesday,** November 5, 1952—1.30 to 6 p. m., only

**Consider carefully each requirement of each problem. Consider technic and neatness as carefully as mathematics. Working papers (but not statements) may be in pencil. All other papers are to be written in ink. The use of a slide rule is permtited.**

**Solve both problems in Group 1 and one of the problems in Group 2.**

### Group 1

1 [20]

Prepare a United States Individual Income Tax Return (cash basis) on Form 1040, supplied to you herewith, for John Taxpayer for the calendar year 1951, complete insofar as the following information makes possible, *except that you need not compute the amount of income tax payable.* No extra forms are available, so it is suggested that you prepare it in pencil to facilitate making corrections. A work sheet is not required.

Mr. Taxpayer's mother, Mrs. Mary Taxpayer, aged 85, who has no gross income, lives with and receives her sole support from Mr. Taxpayer, aged 64, who is single. Their residence is located at 270 Madison Avenue in the city of Springdale in your state.

Mr. Taxpayer is president of the Advance Manufacturing Company from which he received checks aggregating $24,326 on account of 1951 salary (after deduction of $5,620 withholding tax and $54 federal insurance contributions). He also received an expense allowance of $250 per month, out of which he expended $1,700 for railroad travel, meals and lodging while away from Springdale on the Company's business.

He also received an honorarium of $1,000 for his services to the city as a member of its board of aldermen.

During the year, he collected $2,000 from the Conservative Insurance Company as an annuity on a contract which he had purchased some years ago at a cost of $50,000. Mr. Taxpayer had previously reported $18,000 as tax-free income from this contract. Advance Manufacturing Company has a qualified pension plan under which, in the year 1951, $2,000 was set aside for Taxpayer's account.

On January 2, 1908, Taxpayer had acquired a brick store building at a cost of $95,000, of which $60,000 represented cost of the building. At March 1, 1913, the fair market value of the property was still $95,000, of which $81,000 related to the building and $14,000 to the land. The estimated life of the building from January 1, 1908, was 50 years, and from March 1, 1913, was 45 years. Rental income collected in 1951 was $7,500. The lessee paid all expenses except certain repairs amounting to $500, and property taxes of $500, which were paid by Taxpayer.

Interest received consisted of the following items:

| | |
|---|---|
| On \$7,000 2½% U. S. Treasury Notes issued in 1950 .......... | \$175 |
| On \$5,000 Jones Manufacturing Company bonds (These 6% bonds were purchased on October 15, 1951, at 97 and accrued interest of \$100, or a total of \$4,950.) .................... | 150 |
| On \$5,000 Ajax Company bonds which matured December 1, 1950, but which Mr. Taxpayer did not cash until 1951 because the bonds were in a safety deposit box in a Springdale bank, and he was away from the city during the month of December 1950 .................... | 125 |
| On \$4,000 City of Springdale 4% bonds .................... | 160 |

Entries made in Mr. Taxpayer's savings bank pass book included credit for interest:

| | |
|---|---|
| January 2, 1951 .................... | \$109.61 |
| July 2, 1951 .................... | 77.29 |
| January 2, 1952 .................... | 154.28 |

Dividends received consisted of the following items:

| | |
|---|---|
| Cash dividends from stock in MNO Company, a domestic corporation .................... | \$4,000 |

As a holder of 50 shares of PQR Company common stock, Taxpayer received 25 shares of common stock of STU Company. Fair market value of the STU stock at the date of receipt (November 1, 1951) was \$30 per share; at December 31, 1951, the fair market value was \$25 per share.

As a holder of 500 shares of common stock of VW Company, he received 50 shares of that company's preferred stock. Prior to this distribution, the company did not have preferred stock outstanding. The fair market value of the preferred stock at date of receipt (October 15, 1951) was \$50 per share; at December 31, it was \$60 per share.

On January 3, 1952, Taxpayer received and deposited Check No. XL 21245 of the ABD Company, dated December 31, 1951, in the amount of \$300, representing a dividend on 100 shares of this stock held by him on December 31, 1951.

Other cash receipts during the year were:

| | |
|---|---|
| Gift from Taxpayer's uncle .................... | \$2,000 |
| Insurance recovery on fire damage to residence .................... | 500 |
| Settlement of a suit which Taxpayer had brought against the Bijou Theatre of Springdale in 1949 when he tripped on a torn carpet on the theatre staircase, sustaining injuries that required his hospitalization. (Of the amount received, \$1,200 was for reimbursement of medical expenses which he paid in 1951, and \$3,800 was for "pain and suffering.") .................... | 5,000 |
| Winnings at roulette playing, in which he engaged while vacationing in a state where gambling was legal .................... | 1,200 |

His contributions consisted of \$1,500 to the Community Church and \$8,000 to the scholarship fund of Central University.

He paid interest as follows: \$300 on loans on his insurance policy and \$150 on an income-tax deficiency.

Real estate taxes on his personal residence, assessed for 1950 but paid in 1951, were \$850; and personal property taxes, \$50. Automobile license on his car, used entirely for personal (non-business) purposes, cost \$35. Sundry deductible taxes paid during the year amounted to \$375.

He paid \$675 in life insurance premiums and \$110 in premiums on fire insurance policies on his residence; also \$140 in automobile insurance, and \$75 in hospitalization insurance.

Repair of the damage to his residence (caused by the fire on which he collected $500 indemnity) cost him $1,100 and this amount fairly reflects the loss in value caused by the fire.

Hospital and physicians' bills for Taxpayer and his mother aggregated $6,000, of which he paid $4,700 in 1951, paying the $1,300 balance on January 3, 1952. (These amounts are exclusive of what was paid through his hospitalization policy.) Of the $4,700 paid in 1951, $1,200 related to his accident in 1949, described above.

Household expenses, including support of his mother, aggregated $8,000 for the year.

While on a business trip to a state in which gambling was illegal, he played cards with a group he met at the hotel and lost $600.

2 [18]

The Howburne Corporation's condensed statements of income for the fiscal year 1951 and of financial position at the beginning and end of the fiscal year, together with other pertinent data, are reproduced below.

The board of directors of the corporation recognizes that the readers of the corporation's report to stockholders may be puzzled by the fact that, despite a substantial "net income after taxes", the cash balance decreased and the corporation resorted to some long-term borrowing.

Accordingly, the directors have requested that you prepare a statement which will reveal clearly the flow of cash into and out of the Howburne Corporation during the past fiscal year and which will indicate why operations alone did not provide sufficient cash for the corporation's needs.

You have decided that the statement should be constructed to show the cash disbursements other than for operations, the net cash provided by operations, the amount by which operations failed to provide sufficient cash and the manner in which such deficiency was met.

*Required:* Prepare the "Cash Flow" statement (statement of source and application of cash). Prepare a supporting schedule showing the conversion of the income statement to a cash basis, item by item. This schedule should show the amount of cash produced or used as a result of each item on the statement. Use the following column headings in this schedule:

| Per Income Statement | Adjustments to Cash Basis | | Cash Result |
|---|---|---|---|
| | Add | Deduct | |

THE HOWBURNE CORPORATION

INCOME STATEMENT — YEAR ENDED DECEMBER 31, 1951

| | | |
|---|---|---|
| INCOME | | |
| Gross operating income | | $2,410,655 |
| Non-operating income, including dividends and interest | | 21,708 |
| Total income | | $2,432,363 |
| DEDUCTIONS | | |
| Operating charges: | | |
| Materials and supplies used | $870,531 | |
| Wages and salaries | 906,387 | |
| Provision for depreciation charged to operations | 114,079 | |
| Taxes, other than federal income | 26,221 | |
| Other operating charges | 33,762 | |
| Interest charges | 1,297 | |
| Loss on investments | 6,016 | |
| Estimated federal income tax | 284,442 | 2,242,735 |
| NET INCOME (after taxes) | | $ 189,628 |

THE HOWBURNE CORPORATION

COMPARATIVE STATEMENT OF FINANCIAL POSITION

DECEMBER 31, 1950 AND 1951

| | 1951 | 1950 | Increase or Decrease* |
|---|---|---|---|
| *Current Assets:* | | | |
| Cash | $ 215,221 | $ 225,351 | $ 10,130* |
| Marketable securities, at cost | 180,767 | 251,388 | 70,621* |
| Receivable—Trade, less estimated uncollectibles | 266,559 | 195,991 | 70,568 |
| Inventories (at cost) | 322,438 | 359,175 | 36,737* |
| Prepaid operating expenses | 15,209 | 17,894 | 2,685* |
| Total current assets | $1,000,194 | $1,049,799 | |
| *Less—Current Liabilities:* | | | |
| Accounts and notes payable—Trade | $ 108,623 | $ 254,181 | 145,558* |
| Accrued wages and salaries | 12,602 | 11,495 | 1,107 |
| Accrued estimated taxes | 295,580 | 299,466 | 3,886* |
| Dividends payable | 23,726 | 25,591 | 1,865* |
| Accrued interest payable | 750 | 296 | 454 |
| Other accrued operating expenses | 12,622 | 14,942 | 2,320* |
| Total current liabilities | $ 453,903 | $ 605,971 | |
| Working capital | $ 546,291 | $ 443,828 | |
| *Property, plant and equipment,* less amount of cost charged to operations to date | 1,356,132 | 1,200,816 | 155,316 |
| Total assets, less current liabilities | $1,902,423 | $1,644,644 | |
| Deduct—*Long-term bank loans* | 50,000 | — | 50,000 |
| Net assets | $1,852,423 | $1,644,644 | $207,779 |
| *Stockholders' Equity:* | | | |
| Preferred stock, 6% cumulative, par value $100 (2,602 shares) | $ 260,200 | $ 265,200 | $ 5,000* |
| Common stock—par value $100 (12,724 shares) | 1,272,400 | 1,092,300 | 180,100 |
| Amount paid in—in excess of par value | 61,524 | 42,043 | 19,481 |
| Retained earnings | 258,299 | 245,101 | 13,198 |
| Total | $1,852,423 | $1,644,644 | $207,779 |

*Additional information:*

(*a*) During the year, marketable securities were purchased at a cost of $24,692.

(*b*) The "estimated uncollectible receivables" increased $11,448, despite the write-off of $2,605 of bad accounts. During the year, an account of $2,000, written off in a prior year, was recovered; the credit was made to Recovery of Bad Debts which was netted against "other operating charges" in the income statement.

(*c*) During the year, 50 shares of preferred stock were reacquired by purchase at a 9% premium. These shares were cancelled, at which time the excess of the purchase price over the average amount originally contributed for these shares ($105 per share) was debited to Retained earnings.

(*d*) The only entries in the Retained earnings account for the year were for: Net income, dividend declaration, and for the cancellation of preferred stock.

(*e*) There were no sales or retirements of fixed assets during the year.

## Group 2

*Solve any one of the following three problems.*

3 [12]

The C Company is planning a pension system for certain of its employees. It wishes to provide funds for meeting the payments under the pension plan and asks you for assistance.

The company does not contemplate making any pension payments under the plan until January 1963. Payments in 1963 and thereafter to the present group of covered employees are expected to be as follows:

| | | | |
|---|---|---|---|
| January 1, 1963 | $ 5,000 | January 1, 1970 | $22,000 |
| " " 1964 | 7,000 | " " 1971 | 17,000 |
| " " 1965 | 10,000 | " " 1972 | 12,000 |
| " " 1966 | 14,000 | " " 1973 | 8,000 |
| " " 1967 | 16,000 | " " 1974 | 5,000 |
| " " 1968 | 20,000 | " " 1975 | 2,000 |
| " " 1969 | 25,000 | " " 1976 | 2,000 |

Starting on January 1, 1953, and continuing for ten years, the company will deposit $10,000 a year in a special fund. On January 1, 1952, the company wishes to make a lump sum deposit of an amount sufficient to provide the remaining funds needed for meeting the pensions. It is expected that all the above funds will earn 3½% interest compounded annually during the entire life of the fund.

*Required:*

You are to compute the amount of payment which should be made on January 1, 1952. Show all supporting computations in good form.

The following tables of values at 3½% interest may be used as needed:

| Periods | Amount of 1 at Compound Interest | Present Value of 1 at Compound Interest | Amount of Annuity of 1 at End of Each Period | Present Value of Annuity of 1 at End of Each Period |
|---|---|---|---|---|
| 1 | 1.0350 | .9662 | 1.0000 | 0.9662 |
| 2 | 1.0712 | .9335 | 2.0350 | 1.8997 |
| 3 | 1.1087 | .9019 | 3.1062 | 2.8016 |
| 4 | 1.1475 | .8714 | 4.2149 | 3.6731 |
| 5 | 1.1877 | .8420 | 5.3625 | 4.5151 |
| 6 | 1.2293 | .8135 | 6.5502 | 5.3286 |
| 7 | 1.2723 | .7860 | 7.7794 | 6.1145 |
| 8 | 1.3168 | .7594 | 9.0517 | 6.8740 |
| 9 | 1.3629 | .7337 | 10.3685 | 7.6077 |
| 10 | 1.4106 | .7089 | 11.7314 | 8.3166 |
| 11 | 1.4600 | .6849 | 13.1420 | 9.0016 |
| 12 | 1.5111 | .6618 | 14.6020 | 9.6633 |
| 13 | 1.5640 | .6394 | 16.1130 | 10.3027 |
| 14 | 1.6187 | .6178 | 17.6770 | 10.9205 |
| 15 | 1.6753 | .5969 | 19.2957 | 11.5174 |

4 [12]

The Town of Sargentville uses budgetary accounts and maintains accounts for each of the following types of funds:

| Symbol | Fund |
|---|---|
| A | Bond funds |
| B | General bonded debt |
| C | General fund |
| D | Property accounts (general fixed assets) |
| E | Sinking funds |
| F | Special assessment funds |
| G | Special revenue funds |
| H | Trust and agency funds |
| S | Utility funds |
| T | Working capital funds |

The chart of accounts of the *General Fund* follows:

| Symbol | Account |
|---|---|
| 1 | Appropriations |
| 2 | Cash |
| 3 | Due from other funds |
| 4 | Due to other funds |
| 5 | Encumbrances |
| 6 | Expenditures |
| 7 | Reserve for encumbrances |
| 8 | Revenues |
| 9 | Revenues (estimated) |
| 10 | Surplus receipts |
| 11 | Surplus (unappropriated) |
| 12 | 1951 taxes receivable |
| 13 | Vouchers payable |

The following transactions were among those occurring during 1951:

(1) The 1951 budget was approved. It provided for $520,000 of general fund revenue and $205,000 of school fund revenue.

(2) The budgeted appropriations for the general fund amounted to $516,000.

(3) An advance of $10,000 was made from the general fund to a fund for the operation of a central printing service used by all departments of the municipal government. (This had not been budgeted and is not expected to be repaid.)

(4) Taxes for general fund revenues were levied, totaling $490,000.

(5) Contractors were paid $200,000 for construction of an office building. The payment was from proceeds of a general bond issue of 1950.

(6) Bonds of a general issue, previously authorized, were sold at par for $60,000 cash.

(7) Orders were placed for supplies to be used by the Health Department—estimated cost, $7,500.

(8) Vouchers were approved for payment of salaries of town officers in the amount of $11,200. (No encumbrances are recorded for wages and salaries.)

(9) The supplies ordered in item 7 were received and vouchers approved for the invoice price of $7,480.

(10) Fire equipment was purchased for $12,500 and voucher approved.

(11) A payment of $5,000 was made by the general fund to a fund for eventual redemption of general obligation bonds.

(12) Of the taxes levied in item 4, $210,000 was collected.

(13) Taxes amounting to $1,240, written off as uncollectible in 1948, were collected. No amount was in the budget for such collections.

(14) $1,000 of the advance made in item 3 was returned because it was not needed.

(15) Supplies for general administrative use were requisitioned from the store's fund. A charge of $1,220 is made for the supplies.

(16) The general fund advanced $30,000 cash to provide temporary working capital for a fund out of which payment will be made for new sewerage installations. Eventual financing will be by means of assessments on property holders on the basis of benefits received.

(17) Equipment from the Highway Department was sold for $7,000 cash. This sale was not included in the budget and depreciation is not funded.

(18) The town recived a cash bequest of $75,000 for the establishment of a scholarship fund.

(19) Previously approved and entered vouchers for payment of Police Department salaries of $6,200 and for the transfer of $500 to the Police Pension Fund, were paid.

(20) Receipts from licenses and fees amounted to $16,000.

INSTRUCTIONS: Using the answer sheet provided, show for each transaction, by means of the appropriate numerals, the account debited and the account credited in the General Fund. If a transaction requires two entries in that fund, place such entries

one above the other in the appropriate space. If a transaction requires an entry in any fund(s) other than the General Fund, indicate the fund(s) affected by printing the appropriate letter symbol(s) in the column headed "Other Funds Affected." If there is nothing to be entered for a transaction leave the space blank.

The following transaction is already entered on your answer sheet as an example:

*Example:* Collections of taxes belonging to the county amounted to $17,400.

5 [12]

The Specialty Shops Company was unable to meet its obligations. As a result, John Mann was appointed receiver on February 5, 1952. The following trial balance was taken from the books as of that date:

| | |
|---|---|
| Cash | $ 764 |
| Accounts receivable | 5,928 |
| Merchandise | 16,536 |
| Prepayment of expenses | 704 |
| Fixtures | 12,342 |
| Total debits | $36,274 |
| Accounts payable | $15,987 |
| Notes payable | 3,500 |
| Accrued wages, taxes, etc. | 1,275 |
| Accrued rent | 600 |
| Reserve for depreciation | 3,803 |
| Capital stock | 10,000 |
| Earned surplus | 1,109 |
| Total credits | $36,274 |

In the period from February 5 to April 30, 1952, the receiver's actions resulted in the following:

(*a*) An audit of the accounts receivable disclosed that there were an additional $423 of accounts receivable which had not been brought on the books.

(*b*) Merchandise costing $8,310 was sold for cash.

(*c*) A portion of the fixtures, which cost $5,376 and had accumulated depreciation credits of $942, was sold.

(*d*) Accounts receivable totaling $1,882 were collected. Other accounts amounting to $741 have been determined to be worthless.

(*e*) Claims have been approved and paid for $903 of the wages and taxes which were accrued at February 5. Wage claims for $125 which were unrecorded on February 5 have also been approved and paid. Other claims have not yet been paid.

(*f*) Expenses for wages and supplies used in liquidating the business to April 30 amounted to $1,245. Fees for the receiver need not be considered.

(*g*) Rent under leases has continued to accrue in the amount of $900. Interest of $70 has accrued on notes payable.

(*h*) Cash receipts and cash disbursements show the following:

Cash Receipts

| | |
|---|---|
| Collection of accounts | $1,882 |
| Sales of merchandise | 9,108 |
| Sale of fixtures | 1,000 |

Cash Disbursements

| | |
|---|---|
| Accrued wages and taxes | $1,028 |
| Expenses of the receivership | 1,245 |

*Required:*

Prepare either a formal statement of realization and liquidation and related gain and loss account for the period ended April 30, 1952, or a columnar work sheet showing similar information in a logical manner.

## PRACTICAL ACCOUNTING — Part II

**Thursday,** November 6, 1952—1.30 to 6 p. m., only

**Solve all problems.**

1 [12]

F and T are partners in the operation of a retail store. They are concerned about the apparent discrepancy between their income and their volume of sales. Although they maintain incomplete accounting records, their experience in the business suggests to them that there is possible theft or larceny on the part of their staff.

The partners have asked you, in connection with your initial audit (covering the calendar year 1951), to apply such tests as you can to determine whether there is any indication of shortage.

In the course of your investigation you obtain the following facts having a bearing on the problem:

*a* The physical inventory taken December 31, 1951, under your observation, amounted to $4,442 cost, $4,171 market. The inventory of December 31, 1950, was $6,256 cost, $6,013 market. It has been the firm's practice to value inventory at "lower of cost or market," treating any loss or decline in market value as "other expense."

*b* Using the treatment of "loss or decline in market value" of inventory as mentioned in *a* above, the average gross profit in recent periods has been 35% of net sales. The partners inform you that this per cent seems reasonable and that they expected the same result for 1951, since their markup per cent was approximately the same as in the past.

*c* The December 31, 1950, balance sheet shows accounts receivable of $2,057. Notes payable to banks and trade accounts payable were combined on the December 31, 1950, balance sheet. They totaled $9,622. The firm records accounts payable at the net figure, as cash discounts are seldom missed. Purchases have been shown net in past income statements. Sales discounts have been treated as deductions from sales in the past.

*d* During 1951 accounts were written off in the amount of $216, and an account for $148 written off in 1950 was collected and recorded as a regular collection on account.

*e* Unpaid sales slips show that customers owed $3,246 on December 31, 1951.

*f* Unpaid invoices indicate that the firm owed trade creditors $5,027 at the end of 1951. Record of notes outstanding indicates that $3,000 was owed to banks on December 31, 1951.

*g* Sales returns amounted to $95 and purchase returns amounted to $272.

*h* Of the items in the cash records, the following are pertinent:

| | |
|---|---|
| *Receipts:* | |
| From customers (after $272 discounts) | $49,851 |
| From bank loan (net of 60-day, 6% discount) | 2,970 |
| *Disbursements:* | |
| To trade creditors (after $916 cash discounts) | 38,970 |
| To banks on loans | 4,000 |
| To customers for returned goods | 72 |

*Required:*

Compute the amount by which the physical inventory is short, assuming the gross profit rate of 35% is reasonable.

2 [18]

The Mancett Corporation had $105,000 of dividends in arrears on its preferred stock as of March 31, 1952. While retained earnings were adequate to meet the accumulated dividends, the company's management did not wish to weaken its working capital position. They also realized that a portion of the fixed assets were no longer used or useful in their operation. Therefore, they proposed the following reorganization which was approved by stockholders to be effective as of April 1, 1952:

(1) The preferred stock was to be exchanged for $300,000 of 5% debenture bonds. Dividends in arrears were to be settled by the issuance of $120,000 of $10 par value, 5% non-cumulative preferred stock.

(2) Common stock was to be assigned a value of $50 per share.
(3) Goodwill was to be written off.
(4) Property, plant and equipment were to be written down, based on appraisal and estimates of useful value, by a total of $103,200 consisting of $85,400 increase in Allowance for depreciation and $17,800 decrease in certain assets.
(5) Current assets were to be written down by $10,460 to reduce certain items to expected realizable values.

The condensed balance sheet as of March 31, 1952, was as follows:

| | | |
|---|---|---|
| **ASSETS** | | |
| Cash | | $ 34,690 |
| Other current assets | | 252,890 |
| Property, plant and equipment | $1,458,731 | |
| Allowance for depreciation | 512,481 | 946,250 |
| Goodwill | | 50,000 |
| | | $1,283,830 |
| **LIABILITIES AND CAPITAL** | | |
| Current liabilities | | $ 136,860 |
| 7% Cumulative preferred stock ($100 par)* | | 300,000 |
| Common stock (9,000 shares, no-par) | | 648,430 |
| Premium on preferred stock | | 22,470 |
| Retained earnings | | 176,070 |
| | | $1,283,830 |

* $105,000 dividends in arrears.

*Required:*

*A* You are to prepare:

(*a*) The journal entries to give effect to the reorganization as of April 1, 1952. Give complete explanations with each entry and comment as to any possible options in recording the reorganization.

(*b*) A balance sheet as of April 30, 1952, assuming that net income for April was $10,320 after provision for taxes. The operations resulted in $5,290 increase in cash, $10,660 increase in other current assets, $2,010 increase in current liabilities and $3,620 increase in allowance for depreciation.

*B* In making an audit of the Mancett Corporation as of December 31, 1952, you find the following items had been charged or credited directly to retained earnings during the nine months since April 1, 1952:

(*a*) Debit of $14,496 arising from an income-tax assessment applicable to prior years.

(*b*) Credit of $20,387 resulting from gain on sale of equipment which was no longer used in the business. This equipment had been written down by $10,000 increase in allowance for depreciation at the time of the reorganization.

(*c*) Debit of $7,492 resulting from the loss on fixed assets destroyed in a fire on November 2, 1952.

(*d*) Debit of $13,500 representing dividends declared on common and preferred stock.

For each of these items, state whether you believe it to be correctly charged or credited to Retained earnings. Give the reasons for your conclusion. If the item is not handled properly, prepare the necessary correcting entry.

3 [20]

The Superior Hammer Company produces an expensive line of hammers. It operates its own handle department and a foundry department to produce the hammer heads. Assembly and Finishing is a separate department.

In the foundry department, equal parts by weight of pig iron and coke, together with special alloy materials, are introduced into a furnace where the materials are

reduced to molten metal which is poured into molds. The day's work in the foundry is as follows:

(1) Remove and clean the heads cast on the previous day.

(2) Set the molds for the current day's melt.

(3) Load and "burn" the melt for the day.

(4) Pour the metal into the molds.

One-fourth of the labor cost is estimated to be applicable to step number 1.

In the assembly and finishing department, the hammer heads are finished and the handles inserted. Handles are frequently spoiled in the process. Finished hammers are transferred to the stock room immediately.

On October 1, 1952, there was no inventory of any kind in the foundry department. During October 20,000 heads were completed and transferred to the assembly and finishing department. At the end of the month 1,500 good cleaned heads were on hand in the foundry and 1,000 heads had been poured on the last day. A total of 22 tons of pig iron, coke and alloy materials costing $1,248 were placed in production. Direct labor costs for the month amounted to $4,380. Indirect costs were applied at 30% of direct labor cost. A hammer head weighs one pound. An average of ten per cent of the heads poured are not perfect and are remelted.

On October 1 there were 400 hammer heads in the assembly and finishing department on which no work had been done. Their cost was $128.24. There were no handles on hand. During October 20,000 handles costing $9,876 were received in this department. All of the handles were used in completing 19,800 finished hammers. Labor cost amounted to $1,834 and indirect costs to $1,252.

*Required:*

Prepare departmental cost and production reports showing unit production costs and the assignment of these costs to interdepartmental transfers or inventories for the month of October 1952 for the foundry department and the assembly and finishing department. The company uses weighted average cost in its accounts. Unit cost computations should be carried to five decimal places.

## Current Trends in Accounting

(Continued from page 259)

keeps the books:" . . . "long columns of figures beautifully neat."

Came the time when the chancellor explained a shortage of gold to the king. In part, said he, it was caused by too much spending: "The queen", the chancellor reported, "has had three hundred and twenty-four new gowns this year."

But it seemed that the chancellor had been lining his pockets with the king's gold. He was forced to make restitution, and was discharged.

### *Tax Return Lessons in High School*

Recently the *New York World-Telegram and Sun* reported,[48] under the caption "Students to Learn about Income Tax:" "Even the kids are going to learn how to prepare income tax returns." Educational materials to help high school students who had been employed part time were to be distributed all over the country through the secondary schools.

On February 7, 1953, the same newspaper carried an account, illustrated with photographs, of the instruction in income tax filing undertaken at Julia Richman High School in New York City; "enlargements of income tax forms muraled the walls in bizarre display." On the front blackboard had been reproduced in chalk an envelope, big as a doorway, addressed to the Director of Internal Revenue. The students, referred to as "the innocent teen-agers of Accounting 6," filed in for a period of instruction and learned how to fill out the return.

This looks like the beginning of the end for the corner "tax store."

[48] January 7, 1953.

# To Err Is Human

*By* Thomas W. Byrnes, C.P.A.

The above title, taken from Pope's Essay on Criticism contains the foundation of, and the necessity for, auditing. One definition of "to err" is: "to go astray in a *figurative* way" (the italics are mine). Indication of Man's distrust of Man in dealing with and for others can be found in writings dated prior to 3000 BC, in which writings not only is his weakness recognized, but also the means devised by doubting Thomases to discover and correct his mistakes in accounting.

The method adopted by primitive peoples and followed through the Middle Ages was the contemporary compilation of additional records of the same transactions by another set of officials, scribes, or clerks. In the early days of the English Exchequer a third roll was kept by a representative of the King. Following the close of the fiscal period, these separately maintained accounts were meticulously compared by duly authorized officials, adjustments made where necessary, and final settlements determined, after which the accounts were passed as correct.

The verification of accounting responsibilities can be traced from ancient Egypt and Babylon down the centuries to and through the Greeks and the Romans to the rest of the world. There is in existence evidence of audits of communes in Italy during the 13th century; in France the seneschals of the Manors were obliged to answer to auditors for their stewardship at the end of each year, and during this same period in England, all bailiffs, chamberlains, and others accountable for reeipts and disbursements were subject to audit and, if found short, were to be imprisoned on the testimony of the auditors.


Thomas W. Byrnes, C.P.A., has been a member of the Society since 1911, and is a Certified Public Accountant of New York and New Jersey. He is also a member of the American Institute of Accountants.

Mr. Byrnes is a consultant to the accounting firm of Byrnes and Baker, C.P.A's. He was formerly an associate professor of accounting at Columbia University. He is a co-author of the text entitled, "Auditing."


Prior to the 15th century, those responsible for the property of others, were obliged to appear personally and present their accounts orally and, it was not until the accountings had been "heard" that they were accepted and permanently recorded. It is due to this early practice that the critical inspection of material affairs came to be called "auditing", a subject dealing with the analysis of acts of the past, as distinguished from creative or system-devising "accounting."

The 17th century saw a shift from a manor economy to a city or industrial economy. The expansion of trade between the Old World and the New World brought about a fundamental change in the purpose of an examination. Audits of accountabilities were displaced by audits for property and profits or losses arising from commercial, industrial, and financial activities. The scope of audits about that time, and for the next couple of centuries consisted of the examination of documents covering receipts and disbursements, and a comparison of items on the printed balance-sheet with the ledger balances. Toward the latter part of the 19th century it was seen that much more would be required to reflect the true financial position of an enterprise and the results of its operations, and skilled accountants began to advocate the careful taking and valuation of inventories, adequate reserves for

doubtful accounts receivable, and provision for depreciation of plant and equipment; also, they suggested the examination of leasehold and patent rights for the purpose of amortizing such assets, and, the necessity of directing attention to contingent liabilities not shown on the books. The expansion of audit procedures thus begun, has continued and now includes independent verification of all balance-sheet items with sufficient tests of the income and expense transactions to satisfy the auditor of the correctness of the profit and loss account as well.

Mankind has come a long way since the expulsion of Adam and Eve from the Garden of Eden, but the frailty of humans has not changed, and it is the opinion of this aged scribe that it never will. Man may not be inherently dishonest but he is covetous of and careless with his brother's possessions. If, in ancient and medieval times, when life was comparatively simple, it was considered necessary to scrutinize the acts of those charged with custodial duties, how much greater the need for auditing with the growth and complexity of modern affairs.

Auditing has long since demonstrated its value as a necessary adjunct to all activities involving financial responsibility. This is and has been recognized for centuries, but a comparatively recent addition to its acceptance is the establishment of internal auditing departments in countless concerns. The introduction of new methods of accounting presents a challenge to auditors to continue deep study to meet altering conditions. Professional awareness of this is reflected in the helpful bulletins issued from time to time by the national and state accountant societies.

It has been said that text-book writers are inclined to stress fraud too much, and thus may give students the idea that the detection of criminal irregularities is the main purpose of auditing. It is true that at one time in the not too dim and distant past the presence of examiners caused elevation of eye-brows by clients' creditors and neighbors, but today the engagement of auditors is the accepted sign of a progressive management, eager to know if it is on the right track and, if not, why not, and how to correct past mistakes, if any. Also, the public, participating in the ownership of so many concerns, now demands an independent opinion on the conduct of the enterprises.

Tracing the development of auditing through the centuries is a fascinating study, and inquiring readers are referred to the engrossing and complete "History of Accounting and Accountants" by Richard Brown, and the equally interesting "Short History of Accountants and Accountancy" by Arthur H. Woolf.

It may not be amiss, in passing, to admonish young practitioners of auditing: *never take anything for granted,* and to heed the advice of Pliny the Younger: *"never do a thing concerning the rectitude of which you are in doubt."* Also, though in agreement with Alexander Pope that "to forgive is divine" an auditor must always bear in mind that "to err is human."

# New York State Tax Forum

*Conducted by* Benjamin Harrow, C.P.A.

**Real Estate Corporation—Additional Tax**

Under Section 182.2, a real estate corporation is required to pay an additional tax of 2% on any dividend distribution. This tax is also payable on any surplus available for distribution at the time of its liquidation, dissolution, merger or consolidation. Some of the language in the statute raises the question as to when the corporation becomes subject to the additional tax. The law speaks of the tax as being due "at the time of its liquidation or prior to its dissolution."

Suppose a corporation liquidates by distributing its assets, but does not dissolve formally. Does that mean that the corporation is not liable for the additional tax until such time as it dissolves? The Attorney General recently ruled[1] that the tax accrues when the corporation liquidates.

In analyzing Section 182.2 the Attorney General says that the tax accrues under each of several contingencies mentioned disjunctively in the law. One contingency is the distribution at the time of its liquidation. In the case of a dissolution, merger or consolidation, the law speaks of paying the tax "prior" thereto. The Attorney General goes on to say that this language does not give a corporation any option to delay the liability for the tax until it dissolves. That would be contrary to the basic purpose of the provision which was added to the statute in 1930. Dissolution, merger or consolidation is not an inevitable consequence of liquidation.

The Attorney General points out that the taxpayer's contention may be due to the fact that the statute in Section 192 does not require specifically that a report must be filed at the time of liquidation, whereas it does require a report at the time of a dissolution, merger or consolidation. The answer is that a corporation that liquidates, but does not dissolve, will file its regular annual report by March 1 of the succeeding year. Even the requirement of a special report at the time of dissolution is a recent requirement first introduced in 1949. The Tax Commission has always had the power in Section 194 to require supplemental reports "at any time."

It should be noted, as the Attorney General points out, that while Section 197 provides that the franchise taxes imposed by Article 9 are payable at the

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

[1] January 6, 1953.

time of filing the report, Section 182.2 requires payment of the additional tax at the time of liquidation.

**Real Estate Corporation—Apportionment**

The additional 2% tax on liquidation is apportioned on the basis of assets in New York, exclusive of cash, to total assets, "as shown by its annual report for the year preceding." The Attorney General's ruling dealt also with the question of which year's report determines the apportionment of dividends and surplus. If the tax is not due until the filing of the annual report by March 1st of the succeeding year, the apportionment of assets would be based upon the report for the year during which the liquidation took place. This reasoning the Attorney General calls fallacious.

The tax is due at the time of liquidation and therefore the apportionment is based upon the report for the year preceding the liquidation. This is so even though the one mill tax is not due until the following year assuming the corporation does not dissolve. The reason for basing the apportionment of the additional tax under Section 182.2, on the proportion of gross assets within New York in the year preceding the liquidation is to prevent a possibility of evading the tax by reducing gross assets during the year of liquidation or simply retaining only cash assets.

**Department of Taxation and Finance—Collection Bureau**

About a year ago the Tax Commission established a collection bureau. This bureau is divided into two sections, The Metropolitan Collection Section and the Upstate Collection Section. The Metropolitan Section is located at 15 Park Row, New York, N. Y., and originally covered the counties of Bronx, Manhattan, Putnam, Richmond, Rockland and Westchester. It has now been extended to include the counties of Kings, Nassau, Queens and Suffolk. The remainder of the state will be covered from Albany.

The Director of both sections is Mr. Rufus Dillenback, a familiar name on assessment letters. The purpose of the bureau is to centralize collection action against delinquent taxpayers under the Corporation, Income, Miscellaneous and Truck Mileage Tax laws. The new bureau will exercise full collection powers including the imposition of penalties and interest, the issuance of warrants, garnishee proceedings and the sale of property to satisfy tax claims.

The Bureau of Law will continue to be headed by Mr. John Ross, New York City representative. The Judgment Collection unit of the Metropolitan Section of the bureau is presently supervised by Mr. Abraham Blume, Senior Attorney, who has been assigned from the Albany office.

A recent visit to the Metropolitan Collection Section was a most pleasant experience. The offices are new and are bright, airy and comfortable. The representatives of the State Tax Commission were cheerful and helpful. Everything is being done to make the operation upon the taxpayer as painless as possible. We are informed that from the standpoint of collecting revenue, the real purpose of taxes and especially of this bureau, the new office promises to be a great success.

**Payments to a Widow of a Deceased Employee**

Such payments have for a long time presented a serious question as to whether they represented non-taxable gifts or came within the definition of taxable income. A recent Tax Court case[2] presented the question again. In this case an executive of a large newspaper and radio station died. He had been employed by the newspaper for many years. There was no contract of employment and presumably the employment could have been terminated

[2] *Macfarlane* v. *Commissioner*, 19 T.C., No. 2 (October 9, 1952).

at will. Employees and executives each year received a year-end bonus, the amount of which was determined by the president of the company.

The president paid to the widow the sum of $51,580 which was denominated a gratuity. This was about what the employee had received as a bonus for the previous year. The payment was deducted by the employer as compensation paid. The decedent's estate did not report the payment as income and neither did the widow, nor was it included in the gross estate for estate tax purposes. The Commissioner held that the payment was compensation earned by the decedent in his lifetime and so taxable to the widow as the one entitled to receive it at death. (Section 126, I.R.C.) The widow argued that the payment was property acquired by gift and excludible from income under Section 22(b)(3).

The court held that the payment was a gift and not subject to tax. It pointed out that it was the long standing policy of the company to pay bonuses if at all only to those employees on the payroll on the date bonuses were paid. There was no legal obligation to pay the bonus under any employment agreement. The controlling factor said the court was the intent of the payor. In this case the employer wanted to help the widow financially. He was advised by counsel that the payment would constitute a gift to the widow and yet be deductible from income as a business expense. The court also emphasized the fact that the payment was made to the widow and not to the estate.

Under the state Income Tax Law, payments made on or after January 1, 1951, by an employer to the widow or other beneficiary of a deceased employee, in consideration of services rendered by such employee, are taxable to the recipient. Payments made prior to January 1, 1951, are not taxable to the recipient but are treated as nontaxable gifts.

**Real Estate Holding Companies**

To qualify for classification as a real estate corporation taxable under the favorable provisions of Article 9, a corporation must be engaged wholly in certain specified activities. These are principally the purchase and sale of real estate, holding title to real estate, and subleasing real property held under a leasehold of twenty years or more under the terms of which the lessee pays the real property taxes.

A real estate company may hold the entire capital stock of one or more real estate companies, taxable under Article 9 and still retain its own classification as a real estate company. However the parent company must itself own some real estate or be otherwise classifiable as a real estate company. If it is not, then the company is a holding company taxable as a business corporation under Article 9a.

A real estate corporation may own stocks, bonds, or other securities not in excess of 10% of its average gross assets without losing its classification as a real estate company. If it held such securities and, in addition, owned all the stock of another real estate company, it would in our opinion still be classified as a real estate corporation. While the law is not clear on this point, there are two separate provisions in the law concerning the effect of such holdings on the company's classification and it would seem that they are intended to be applied separately.

It should be emphasized that the real estate holding company must own the entire capital stock of the subsidiary company and not merely a controlling interest, no matter how large.

It should also be noted that there is no similar provision in the case of transportation companies taxable under Sections 183 and 184 of Article 9. Therefore, a corporation owning all the stock of one or more transportation companies would itself be taxed as a business corporation and would not be permitted the advantages of a classification as a transportation company.

### Activities That May Result in Loss of Classification as a Real Estate Corporation

The statute is silent on whether renting and managing property owned by the corporation is a permissible activity. There would seem to be an implication in the terms "purchase" and "sale" that there will be a period between the purchase and sale when the corporation will hold, manage, rent and operate the real estate. But managing real property for others for a fee is definitely a proscribed activity for a real estate company under Article 9. Nor may a corporation act as a real estate broker or insurance agent and still be classified as a real estate corporation. Investment in property other that real estate is permitted on a limited basis, namely 10% of the average gross assets.

If a business corporation owns or controls a real estate corporation or if the same interests own or control the stock of both corporations, and if in addition the business corporation uses or occupies a material part of the property of the real estate corporation, the classification of the real estate company is lost and it becomes subject to tax as a business corporation under Article 9a.

There is no guide in the law as to what constitutes a material part of the property of the real estate corporation. It probably means a significant or important part of the property. The issue would have to be determined on the basis of the facts presented to the alert Tax Commission.

Questions 8 and 9 on Form 42 CT are designed to elicit all necessary information on the activities of the corporation to enable the Tax Commission to determine whether the corporation has been properly classified as a real estate company.

### Real Estate Corporations— Loans to Stockholders

This is a proscribed activity that merits special observation. It is not considered a valid real estate activity and in recent years the Tax Commission has made uncomfortable inquiries where such loans appear on the balance sheet.

Such loans may be treated as a dividend distribution and taxed as such if the circumstances indicate that they were really intended to be a disguised distribution out of surplus. However, if the loans are taxed as dividends, the corporation will not be reclassified as a business corporation.

### Amortization of Bond Premiums

Under the Internal Revenue Code amortization of bond premiums is treated as an allowable deduction from gross income, (Section 23(v)). The amortization provision was first introduced in the Code by the Revenue Act of 1942. It was probably intended to prevent a capital loss deduction in the case of tax-exempt bonds purchased at a premium and then sold or redeemed at a loss, the collection of the interest meanwhile escaping taxation. From a sound accounting standpoint a bond premium is recovered through the collection of interest.

Under Section 124 of the Internal Revenue Code all taxpayers must now amortize bond premiums on tax-exempt bonds. Corporations must also amortize bond premiums on partially tax-exempt bonds, although amortization on such bonds is optional with individual taxpayers. All taxpayers have the option to amortize bond premiums on fully taxable bonds. The effect of this deduction for amortization of bond premiums on fully taxable bonds is to reduce the income currently and, also, to reduce the cost or basis of the bond. The effect of the latter provision is to reduce any deductible loss upon the disposition or redemption of the bond.

Generally the amount amortizable for any year is the amount attributable to such year. This amount may be determined in accordance with any reasonable method used by a bondholder. As a rule the premium is amortizable

ratably over the period from the date of acquisition of the bond to the date of maturity. However, in the case of a bond callable at a date before maturity the premium may be amortized over the period from the date of acquisition to the call date. It should be noted that premiums attributable to a conversion feature in a bond are not deductible in taxable years beginning after June 15, 1950.

Taxpayers should be aware that there are no similar provisions in the State income tax law for individuals. However, with respect to estates and trusts the Regulations (Article 252) provide that where a fiduciary has adopted a consistent plan for amortizing premiums on bonds bought by him in order that at maturity of the securities the corpus will not have been lessened, and if there has been an actual setting aside of income for such purpose, a deduction for amortization will be allowed. The regulation speaks of amortization, as here used, as meaning the "wearing away" of the premium paid by the fiduciary on the purchase of bonds subsequent to the creation of a trust (and presumably an estate).

### Deductibility of Federal Social Security Taxes—Income Tax

Section 480 of the Internal Revenue Code provides for a social security tax upon self-employment. Deputy Commissioner Kassell has ruled on the question of the deductibility of this tax in computing taxable net income. He says that the tax is part of the income tax and "is subject to the jurisdiction of the Tax Court of the United States to the same extent and in the same manner as the other taxes under Chapter 1 of the Internal Revenue Code." Income taxes are not deductible in computing net income under Section 360.3 of the Tax Law. The same rule applies to the Unincorporated Business Tax.

### Tax Liability of Estates

A fairly common situation was submitted recently to us. An estate was in process of administration, 1952 being the second taxable year. The income of the estate consisted of about $6,000 of dividends and a $5,000 capital gain. Under the will of the decedent the entire estate was left to the wife. Who is taxable on the income of the estate for 1952?

An estate is a taxable entity and under Section 365 the law states that the income tax is applied to estates upon the income of the estate. Such income includes "income received by estates of deceased persons during the period of administration or settlement of the estate." Article 242 of the Regulations, in amplifying this provision of the law, states that income of the estate of a deceased person which during the period of administration is properly paid or credited to any legatee, heir, or other beneficiary, is taxable to the beneficiary. This is stated as an exception to the rule that income is taxable to the estate during the period of administration.

Article 242 also provides that income is taxable to the beneficiary if it is to be distributed periodically and that includes income for the taxable year of the estate which became payable to the beneficiary within the taxable year of the estate.

Section 365.3 of the law provides that in determining the net taxable income of the estate of a deceased person during the period of administration, income properly paid or credited to any beneficiary may be deducted by the estate in arriving at its net income.

On the basis of the above references to the law and regulations, if the dividend income had actually been distributed, in our opinion it would be taxable to the beneficiary and deductible by the estate. If it was set apart or credited to a beneficiary but not actually paid to him by the executor, it would still be taxable to the beneficiary.

With respect to the capital gain the rule is different. A capital gain be-

(Continued on page 293)

# Accounting at the S. E. C.

*Conducted by* Louis H. Rappaport, C.P.A.

UNDER the Securities Act of 1933 the SEC has broad powers to carry out the provisions of the Act. The Commission is authorized to make rules and regulations governing registration statements and prospectuses and defining accounting and technical terms. Among other things, the Commission has the authority to prescribe:

1. The form in which required information shall be set forth;
2. The items or details to be shown in the financial statements;
3. The methods to be followed in the preparation of accounts, in the appraisal or valuation of assets, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, and in the preparation of consolidated statements.

Under its authority the SEC has prescribed a series of forms for the registration of various types of securities and issuers under the Act. The Commission has also promulgated Regulation S-X which is the principal regulation dealing with the form and content of financial statements filed under the 1933 Act and also under the 1934 Securities Exchange Act.

The Commission has, for the most part, been content to let the accounting profession make the pronouncements as to accounting principles. On occasion the Commission has registered official disapproval of a position taken by the profession. (See, for example, the SEC's Accounting Series Release No. 53 which disagreed, in part, with the position taken by the AIA in its Accounting Research Bulletin No. 23.)

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's.

An accountant who certifies statements for filing with the SEC should be familiar with the Commission's views on accounting matters, whether expressed in regulations, decisions or reports. Fortunately, the requirements of the Commission and those of the profession have, with a few exceptions, been parallel. As a result the financial statements included in the majority of published reports to stockholders do not differ materially from those included in reports filed with the SEC. With the passage of time it is believed that the differences between the two sets of statements are being reduced. It would be regrettable indeed if the SEC had evolved a set of accounting principles which were different in important respects from those generally accepted by public accountants, industry and investors.

There are indications, however, that a difference of opinion may be developing between the SEC and the profession involving an important accounting matter, namely, the accounting for compensation involved in stock option plans. The most recent authoritative statement on that subject is contained in Accounting Research Bulletin No. 37 issued in January, 1953, by the AIA Committee on Accounting Procedure, and reproduced in the March, 1953, issue of this magazine (pp. 229-232). As our readers know, this bulletin revises in important respects the position previously taken by the Committee in November, 1948. In short the Committee now concludes that in most cases (including situations where the right to exercise an option is conditional upon

continued employment) valuation of the option should be made as of the date of the grant.

That the SEC may take a contrary position on this question is evident from a recent Commission release which invited comment on or before April 25, 1953, on a proposed accounting rule. The release is reproduced below:

## PROPOSED ACCOUNTING RULE

### NOTICE OF OPPORTUNITY FOR COMMENT ON PROPOSED RULE CONCERNING TREATMENT OF COMPENSATION IN THE FORM OF STOCK OPTIONS GRANTED BY CORPORATIONS TO THEIR OFFICERS AND EMPLOYEES

During the past decade an increasing number of industrial companies which file financial statements with the Securities and Exchange Commission have adopted a plan or plans for granting options to key officers and employees, usually a small number of persons, to purchase capital stock of such companies. While some of these plans have given the optionees the unrestricted right to exercise the options immediately, others have required that the optionees remain in the employ of the company for a specific period before they have the unrestricted right to exercise the options, and still others have granted the right to purchase a specified number of shares each year over a period of years provided the optionees were in the employ of the company upon each such option date.

Prior to 1950 many of these plans fixed the purchase price at substantially less than the market price of the stock optioned at the date the option was granted. In 1950 Section 130A of the Internal Revenue Code was enacted which created the "restricted stock option" defined as "an option granted after February 26, 1945 to an individual, for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any such corporations, but only if * * * at the time such option is granted the option price is at least 85 per centum of the fair market value at such time of the stock subject to the option; and such option by its terms is not transferable by such individual, * * * and is exercisable, during his lifetime, only by him * * *."

Pursuant to Section 130A no tax is required to be paid by an optionee with respect to the optioned shares until he disposes of such shares, provided dispositon thereof is not made within two years from the date of the granting of the option nor within six months after the transfer of the optioned shares to him. If these conditions are met, and the option price is between 85% and 95% of the fair value of the stock at the date of grant, the gain upon disposition is taxable as compensation only to the extent that the option price is exceeded by the lesser of the fair market value of the stock at (1) the time of disposition, or (2) the time the option was granted. If these conditions are not met or in the case of a non-restricted option, any excess of the fair market value as of the date on which the option was exercised over the option price of the shares optioned would be taxable as compensation.

Where the conditions of Section 130A are met, no tax deduction is allowable to the corporation at any time by reason of stock purchased by employees under a restricted option plan, whereas otherwise an amount equal to the aggregate excess of the fair market value of the optioned shares over the option price thereof on the date such shares are acquired by the optionees is deductible for tax purposes by the corporation.

Since the enactment of Section 130A many corporations have changed their methods of granting options to qualify them as restricted options. While some of these plans set the option price at varying amounts (but not more than 15%) under the market price, in most instances the option price is the same as market.

Stock option plans, whether or not they meet the conditions specified in Section 130A, unquestionably afford benefits to the participating employees which are susceptible of monetary expression. This has been generally recognized in court decisions, in the varying treatments which have been accorded such options under the Internal Revenue Code, and in financial statements filed with the Securities and Exchange Commission. Accordingly, the Commission has required financial statements filed with it to reflect amounts corresponding to the benefit to the optionees as charges against income of the issuer in the period or periods in which the optionees first obtained the unrestricted right to exercise their options.

This accounting for the compensation resulting from the option agreements was concurred in by the accounting profession in November 1948 through the issuance by the Committee on Accounting Procedure of the American Institute of Accountants of their Accounting Research Bulletin No. 37 entitled "Accounting for Compensation in the Form of Stock Options," which expressed the view that: (1) the options are part of the corporation's cost of the services of officers and other employees, and should be accounted for as such; (2) the omission of such costs from the corporation's income accounting may result in overstate-

ment of net income to a significant degree; (3) the proper date as of which to measure the value of the option is the date the grantee has met all conditions which would permit him to exercise the option; and (4) the cost of such services to the corporation should be measured by the excess, at such date, of the fair value of the shares then exercisable over the option price thereof.

The American Institute of Accountants has reconsidered its Accounting Research Bulletin No. 37 and now, after several years of acceptance by the accountants certifying financial statements made available to investors through filings with the Securities and Exchange Commission and in corporate reports to stockholders, has revised that bulletin to establish the date on which an option is granted as the date on which such compensation is to be determined and to indicate that the amount of compensation to be recorded in the accounts of the corporation should be merely the excess of the fair value of the optioned stock over the option price as at that date.

Acceptance of the method prescribed in the revised bulletin would result in the almost complete exclusion from corporate income statements of charges for compensation to employees in the form of stock options; for most option plans are no longer of the unrestricted type and under the restricted plans the option price is fixed generally at market or within 95% of market.

In view of the revision of Accounting Research Bulletin No. 37, the Commission deems it necessary and appropriate to give consideration to the adoption of a rule requiring a corporation which grants options to its officers and employees to acquire its capital stock, thereby incurring costs in the form of compensation to the optionees, to account for such costs, at the time the optionees have complied fully with the terms of the option, by charging corporate income with an amount equal to the fair value of the stock over the option price at that date. This would continue in effect the procedure the Commission has required in the past.

Until the Commission has had full opportunity to receive and study the views of all interested persons, and the proposed rule is adopted or otherwise disposed of, registrants will be permitted to disclose in footnotes to the financial statements filed with the Commission all pertinent details relative to outstanding option arrangements in lieu of accounting for the compensation resulting therefrom as required in the past. This interim treatment is not to be construed as indicative of the Commission's ultimate decision with respect to the proposed rule but merely recognizes the difficulty of determining appropriate accounting procedures with respect to these option arrangements which in many instances materially affect financial statements.

The text of the rule, which it is proposed to adopt pursuant to authority conferred upon the Commission, . . . is as follows:

"CAPITAL STOCK OPTIONED TO OFFICERS AND EMPLOYEES

"(a) Compensation to officers and employees in the form of options granted to acquire capital stock should be reflected in the profit and loss account, at the time the optionees have complied fully with the terms of the option agreements and thereby become entitled to exercise the options, in an amount equal to the excess of the fair value of the stock exercisable over the option price, at that date.

"(b) A brief description of each option arrangement including (1) the title and amount of securities subject to option; (2) the date or dates upon which the options were granted; (3) the date or dates upon which the optionees become entitled to exercise the options; (4) the option price or prices; (5) the fair value per share of the optioned shares at the dates the options were granted; and (6) the fair value per share of the optioned shares which became exercisable during the period should be shown in the footnote to the financial statements."

## AN ADIRONDACK VIEW

**Two Sides** there are to every question, that is what they say—and write in books. Some people insist that there is only one side—their side. Others are broader minded, they admit there are two sides, the wrong side—yours; and the right side—theirs.

One of the recently appointed "progressional" committees of this chapter has held hearings on this pattern of thought. And finds as follows:

1. When two persons consider a matter there are three answers—the answer of #1 person, the answer of #2 person, and the right answer.

LEONARD HOUGHTON, C.P.A.
Of the Adirondack "Chapter."

# Payroll Tax Notes

*Conducted by* Samuel S. Ress

## Federal Withholding and Social Security Taxes

### How to Obtain a 10-day Extension for Filing Quarterly Payroll Tax Report

Federal payroll taxes deducted periodically for employees' income and social security taxes must be remitted quarterly to the Director of Internal Revenue by the employer. If more than $100 per month is deducted, the employer is required to deposit the withholding and social security taxes with a duly authorized depositary which validates a Form 450 Depositary Receipt for the employer. The deductions for the last month in the quarter may be paid by cash or check, even though more than $100 had been deducted from employees' wages for payroll taxes. However, if the entire quarter's taxes are paid with depositary receipts, the time for filing the detailed quarterly Federal Payroll Tax return (Form 941) is extended from 30 or 31 days following the close of the quarterly period to 40 days. In this way an employer may get a 10-day extension of time for filing the report without incurring a 5% penalty on top of the tax liability.

Samuel S. Ress has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

## New York State Unemployment Insurance

### Voluntary Leaving of Employment for Reasons of Health

In Appeal Board Case #33,924-52, decided January 23, 1953, it was held that physical inability to continue work is not good cause for quitting a job, if the benefit claimant fails to exercise a right under a union contract to demand work not detrimental to her health.

In this case the claimant had been paid on a piece-rate basis. Her doctor had advised her that working on a piece-rate basis was detrimental to her health and responsible in part for a nervous condition for which she was being treated. The Referee found in her favor, that under such circumstances her voluntarily leaving employment was with good cause. The employer appeared at the hearing before the Referee. Having made an appearance before the Referee, he had the right to appeal from the Referee's decision in favor of the claimant; if he had not appeared at the Referee's hearing he would have been barred from filing an appeal. In this case the Industrial Commissioner decided to go along with the Referee's decision, even though it had upset the original determination of the Commissioner denying benefits to the claimant.

The Appeal Board modified the Referee's findings of fact and conclusions of law following the employer's appeal so as to deny benefits to the claimant for a 42-day period as a voluntary "quit" without good cause.

# Office and Staff Management

**A forum for the exchange of views and information on all aspects of the administration of an accounting practice.**

*Conducted by* MAX BLOCK, C.P.A.

### State Rules of Unprofessional Conduct and Advertising

Certified Public Accountants licensed by the State of New York are now governed by law with respect to their professional conduct and means of promotion. It does not matter whether one is a member of the New York State Society of Certified Public Accountants or not. Section 94 of the Regulations of the Commissioner of Education contains the Code of Ethics to which all New York Certified Public Accountants are subject.

The State Society has recently mailed copies of the new rules to CPA's, whether or not members. If you have not received a copy, or know one who has not, a copy can be obtained upon request.

The new rules, which closely resemble those of our state and national societies, should be carefully read to avoid unintentional violations. Moreover, flagrant violations of the code should be reported when observed. This is the only way that the small marginal fringe who are unconcerned with standards can be eliminated or made to comply.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

### Tax Return Instruction Sheets

In the February, 1953, column (page 157) there were reproduced copies of two tax return instruction sheets, one for state returns and the other for federal returns. They were considered to be an improvement over individual instructions for each type of tax return.

However, another practitioner, David Baumgarten, C.P.A., sent in a "universal" form, one that he uses for every type of return. The form excludes certain data which some accountants deem essential, such as the address of the tax office, or provision for detailed instructions regarding signatures, for example, where two specific signatures are required on the federal corporation income tax return. These deficiencies can be corrected by expanding the instructions or, in the case of addresses, the use of rubber stamps.

An added feature is the inclusion of data for "General Ledger Account To Be Charged." This may be of help in the case of companies whose bookkeepers are inexperienced or new. It is worthy of consideration, and thanks to Mr. Baumgarten for sending it in.

**Office Methods Check List**

Auditors are expected to be alert to system improvements. This is a means of rendering an extra service to clients. In many instances clients assume that their accountants will detect all inefficiencies and do something about their correction. If a situation of unnecessary paper-work is discovered by such a client he may well feel that the accountant has been lax.

Staff members should be urged to be on the lookout for system recommendations; in fact, this point could well be made part of the audit program. Suggestions should, as a rule, be brought to the attention of the supervising partner by the staff member rather than to the client directly. This will permit the screening of ideas.

To insure consideration of the soundness of office systems one progressive firm has developed a questionnaire form. It is used on new engagements particularly, and at intervals even on old clients. It is all in the form of questions, such as, "if statements (customers) are sent out, is this necessary? ————." "Do customers require them? ————."

Accountants could well devise such a form for themselves and thereby be sure that the system review is dealt with effectively.

## New York State Tax Forum

(Continued from page 287)

comes an addition to the corpus of the estate and is not includible in "the amount of any income paid or credited to any . . . beneficiary" within the meaning of Section 365(3) when it is distributed to a beneficiary. Such income would therefore be taxable to the estate under all circumstances. Our courts have so ruled on this situation.[3]

If the beneficiary is a non-resident, the dividend income would escape any tax by New York since "a non-resident beneficiary is taxable only on such part of his income from the estate or trust as arises from sources within the State of New York (exclusive of annuities, interest on bank deposits, interest on bonds, notes . . . or dividends from corporations . . .") Reg., Art. 245.

In these situations it may be important to know what is meant by the period of administration. Article 249 of the Regulations defines the period of administration or settlement of the estate as "the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates . . .".

[3] *Bank of Richmondville and Holmes, Executors of the Will of William E. Lewis* v. *Groves et al.*, 259 App. Div. 4 (1940); affd., 284 N. Y. 671.

# OFFICIAL DECISIONS *and* RELEASES

## EIGHTEENTH ANNUAL REPORT
## of the
## SECURITIES AND EXCHANGE COMMISSION
## (Fiscal Year Ended June 30, 1952)

### Section Dealing With the Activities of the Commission in Accounting and Auditing

Dependable, informative financial statements, i.e., statements which disclose the financial status and earnings history and potentialities of a corporation or other commercial entity, are indispensable to the investor as a basis for investment decisions. Recognizing the importance of these statements and aware that they lend themselves readily to misleading inferences or even deception, whether or not intended, the Congress, in the various statutes administered by the Commission, dealt extensively with financial statement presentation and the accounting concepts and principles on which they are based. Consequently the activities of the Commission in the field of accounting are highly significant.

Thus, for example, the Securities Act requires the inclusion in prospectuses of balance sheets and profit and loss data "in such form as the Commission shall prescribe,"[1] and authorizes the Commission to prescribe "the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts * * *."[2] Similar authority is contained in the Securities Exchange Act,[3] and more comprehensively power is embodied in the Investment Company Act[4] and the Holding Company Act.[5]

The Securities Act provides that financial statements required to be made available to the public through filing with the Commission shall be certified by "an independent public or certified accountant."[6] The other three statutes referred to above permit the Commission to require that such statements be accompanied by a certificate of an independent public accountant,[7] and the Commission's rules do require, with minor exceptions, that they be so certified. The value of certification by qualified accountants has been conceded for many years but the requirement as to independence, long recognized and adhered to by some individual accountants, was for the first time authoritatively and explicitly introduced into statutes. Out of this initial provision in the Securities Act and the resulting rules promulgated by the Commission,[8] together with stringent action taken by the Commission in certain cases,[9] there have grown concepts of accountant-client relationships that have strengthened the protection afforded investors.

As shown above, the statutes administered by the Commission give it broad rule-making power with respect to the preparation and presentation of financial statements. Pursuant to this authority the Commission has prescribed uniform systems of accounts for companies subject to the provisions of the Holding Company Act;[10] has adopted rules under the Securities Exchange Act governing accounting and auditing of securities brokers and dealers; and has promulgated rules contained in a single, comprehensive regulation identified as Regulation S-X,[11] which govern the form and content of finan-

[1] Sec. 10(a)(1) (Schedule A, paragraphs 25, 26).
[2] Sec. 19(a).
[3] Sec. 13(b).
[4] Secs. 30, 31.
[5] Secs. 14, 15.
[6] Sec. 10(a)(1) (Schedule A, paragraphs 25, 26).
[7] Securities Exchange Act, sec. 13(a)(2); Investment Company Act, sec. 30(e); Holding Company Act, sec. 14.
[8] See, for example, rule 2-01 of Regulation S-X.
[9] See, for example, Securities Exchange Act release No. 3073 (1941); 10 S. E. C. 982 (1942); and Accounting Series release No. 68 (1949).
[10] *Uniform System of Accounts for Mutual Service Companies and Subsidiary Service Companies* (effective August 1, 1936); *Uniform System of Accounts for Public Utility Holding Companies* (effective January 1, 1937; amended effective January 1, 1943).
[11] Adopted February 21, 1940 (Accounting Series release No. 12); revised December 20, 1950 (Accounting Series release No. 70).

cial statements filed in compliance with the various Acts. This regulation is implemented by the Accounting Series releases, of which seventy-three have been issued at this writing, inaugurated in 1937 and designed as a program for making public, from time to time, opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions. The rules and regulations thus established, except for the uniform systems of accounts, prescribe the accounting to be followed only in certain basic respects. In the large area not covered by such rules the Commission's principal reliance for the protection of investors is on the determination and application of accounting principles and standards which are recognized as sound and which have attained general acceptance. This policy of the Commission is expressed in Accounting Series release No. 4 (1938).

It is essential that the Commission keep abreast of changes and new developments in financial and economic conditions in order to make certain that the effects thereof on the operations and financial status of the several thousand commercial and industrial companies required to file financial statements with the Commission are properly reported to investors. To accomplish this the Commission's accounting staff engages in study and research projects designed to establish and maintain appropriate accounting procedures and practices. The primary responsibility for this program rests with the Chief Accountant of the Commission who has general supervision with respect to accounting and auditing policies and their application.

These activities require constant contact and cooperation between the staff and accountants both individually and through such representative groups as, among others, the American Accounting Association, the American Institute of Accountants, the Controllers Institute of America, and the National Association of Railroad and Utilities Commissioners, as well as with other governmental agencies. Recognizing the importance of continued close cooperation in the formulation of accounting principles and practices which will best serve the interests of investors, both the American Institute of Accountants and the Controllers Institute of America regularly appoint committees "on cooperation with the S. E. C." which keep in touch with the Commission's staff. The Chief Accountant of the Commission acts as a "consultant" to the American Accounting Association Committee on Concepts and Standards and as a "conferee" of the Committee on Accounts and Statistics of the National Association of Railroad and Utilities Commissioners. Each of these latter two committees holds periodic meetings for the purpose of discussing accounting and financial matters of mutual interest.

While examination and reexamination of sound and generally accepted accounting practices consume a large part of the time of the chief accountant's staff, the many daily decisions of the Commission require the almost constant attention of some of the staff. These include questions raised by each of the operating divisions of the Commission and the regional offices, as well as the Commission itself. From time to time members of this staff are called upon to assist in involved field investigations, to participate in hearings, and to review opinions in so far as they pertain to accounting matters. On several occasions the staff has furnished one or more persons to assist Congressional committees.

Considerable time is also spent in prefiling and other conferences, in person or by phone, with the officials of corporations, practicing accountants, and others. This procedure, which has proved to be one of the most important functions of the office of the chief accountant, saves registrants and their representatives both time and expense.

### Developments in Accounting Principles and Procedures

During the fiscal year the continued high level of business activity, and the threat of a reversal to a wartime economy, accompanied by increasing price levels and income taxes, stimulated an unusual amount of discussion in financial, industrial and accounting circles of certain basic problems in corporate accounting and financial reporting. Many problems which developed and were first dealt with during the period of World War II required reconsideration in the light of existing conditions. For example, there was a renewed advocation—not concurred in to any large extent by accountants and corporate officials generally—for the application of the theory that depreciation of fixed assets is related directly to replacement and that provisions from income for depreciation are inadequate unless they will provide for the replacement of the applicable assets at the time they are retired from service. Some holders of this view would, in effect, abandon historical costs completely by adjusting such costs, in financial statements, to reflect changes in purchasing power of the dollar.

In reports for previous years[12] the Commission made it clear that it would continue to require adherence to historical costs in statements filed with it. The Commission has found no justification for changing its requirements in this respect.

[12] Fourteenth Annual Report, p. 111; Fifteenth Annual Report, p. 179.

## NEW YORK STOCK EXCHANGE

### Statement on Stock Dividends

The accounting treatment for stock dividends has been the subject of study by the Exchange and others over a period of years.

Stock dividends have been most helpful to the share-owners of many companies when a substantial part of the earnings have not been available for cash dividends because of reinvestment of earnings in the business. However, to pay out in stock dividends, on a continuing basis, more than is being reinvested in the business through earnings may be misunderstood by share-owners and the investing public. The dilution thus suffered, which might not become apparent for some time, would not occur if the stock dividend were capitalized, at its fair value, out of earnings during the period covered by the dividend.

The Exchange, from time to time, has issued statements defining its policy in relation to authorization of the listing of additional shares to be distributed pursuant to stock dividends. The following statement supersedes all such statements of policy heretofore issued, most recent of which was dated May 28, 1948.

### Exchange Policy

The Exchange, in authorizing the listing of additional shares to be distributed pursuant to a stock dividend (or a stock split-up, whether or not effected through the technique of a stock dividend) representing less than 25% of the number of shares outstanding prior to such distribution:

(1) will expect that, in respect of each such additional share so distributed, there be transferred from earned surplus to the permanent capitalization of the company (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of such share, it being understood that, while it is impractical to define "fair value" exactly, it should closely approximate the current share market price adjusted to reflect issuance of the shares to be distributed; and

(2) will consider the relationship between the aggregate fair value of the shares so to be distributed and the amount of the company's earnings.

This Policy is applicable to all such distributions amounting to less than 25% of the number of shares outstanding immediately prior to the distribution, whether such distributions are represented to be stock dividends or stock split-ups. It is not intended to apply to distributions representing 100% or more of the number of shares outstanding prior to the distribution. As to distributions falling between those two limits, while there may be a general presumption that they need not be accounted for in accordance with this statement of policy, the validity of that presumption can only be determined in the light of all circumstances pertaining to the particular case, including, among other things, market price, the frequency with which such distributions recur, and changes in conditions between successive distributions.

In considering the relation of the aggregate fair value of the additional shares to be distributed to the company's earnings in accordance with the paragraph numbered 2 above, the Exchange will expect that the undistributed earnings of the period between successive distributions be sufficient to cover such aggregate fair value. Exception to this phase of the policy may be made in the case where two or more such distributions occur during the same fiscal period and the undistributed earnings of such fiscal period are sufficient to cover the aggregate value of all such distributions occurring during such fiscal period although the undistributed earnings of the period between two successive distributions may not be sufficient to cover one distribution or the other. Otherwise, while an occasion may arise when the aggregate fair value of shares issued in successive distributions may exceed the undistributed earnings between such successive distributions, the Exchange is not prepared to make exceptions to the above-stated policy except under the most unusual circumstances and on a non-recurring basis.

In the case of an initial distribution, it would be appropriate to take into consideration the undistributed earnings of a reasonable number of prior fiscal periods.

A notice should be sent to stockholders with the distribution, showing the amount transferred from earned surplus in respect of each share distributed, the aggregate amount so transferred, and the relationship of such aggregate amount to undistributed current earnings, and the percentage by which each stockholder's interest in the company will be reduced if he disposes of the distribution shares.

February 19, 1953

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